Water today, water tomorrow

Future price limits – statement of principles

OFWAT

About this document

After we last set price limits in November 2009, we started a wide-ranging and in-depth review of our regulation to see if it was fit for purpose in the face of the challenges facing the water and sewerage sectors in England and Wales. This is our future regulation programme of work.

Our own review coincided with the following independent reviews into the sectors, which were very helpful in informing our work.

- The review of the 2007 floods, chaired by Sir Michael Pitt (the 'Pitt review'), which identified lessons from the floods that affected England and Wales during that summer.
- The review of competition and innovation in water markets, chaired by Professor Martin Cave (the 'Cave review'), which examined the role that competition and innovation could play in ensuring the sectors have the solutions and tools necessary to meet the challenges of the future.
- The review of charging for household water and sewerage services, chaired by Anna Walker (the 'Walker review'), which examined fair and sustainable charging for household water and sewerage services.
- The review of Ofwat and consumer representation in the water sector, commissioned by Defra and led by David Gray (the 'Gray review'), which assessed whether Ofwat was fit to face the challenges of the future.

And crucially over the past two years, the extensive engagement of our stakeholders has helped shape our proposals for how we can adapt our regulatory approach to modernise it – and make it more flexible and responsive – while building on and retaining those important elements that work well.

As part of that engagement process, we published a number of documents, including:

- 'Beyond limits – how should prices for monopoly water and sewerage services be controlled?' in July 2010; and
- 'Lessons from our approach to setting price limits (PR09)' in December 2010.

And we have published discussion papers and consultants' reports on a wide range of topics. These are available in the future price limits section of our website. In November 2011, we consulted on our proposals in 'Future price limits – a consultation on the framework', which we supported with extensive stakeholder engagement.

This document is the result of all of that valuable work and input. It sets out the high-level principles that we intend to use to guide us in how we set price limits. And it provides an indication of how those principles will shape the framework for the next price review and beyond. We highlight those elements of the framework that we are likely to apply at the next price review – as well as those areas where we need to do additional work to decide whether we need to take a more phased approach to development and implementation.

Appendix 1 to this document (published separately) provides an updated impact assessment based on the principles and the framework as described in this document. Appendix 2 summarises the responses we received to our consultation and describes how we are addressing them.

Many of the comments we received relate to very valid and important questions of how the detail of the framework will operate. This includes further policy decisions, such as the precise definition of retail services, and implementation questions about how we will handle legacy mechanisms like the capital expenditure incentive scheme (CIS).

So, alongside this document we have published 'From principles to price setting – next steps'. This sets out the work we intend to do between now and the autumn to address these useful comments. It also shows stakeholders how they can be involved in and influence our thinking during this phase of our work. The result of that work will be our proposed methodology for setting price limits in 2015, on which we will consult in the autumn.

Contents

1. Introduction

1.1 A sound foundation

Over the past 23 years, the water and sewerage sectors in England and Wales have successfully delivered safe, secure drinking water and a much-improved environment. In that time:

- underinvestment in infrastructure has been turned around;
- basic customer service has improved; and
- bills – although increasing – have been kept down by the efficiency challenge of our regulation.

And investment of more than £98 billion has been attracted to the sectors from private capital markets. So, this success has been achieved at no cost to the taxpayer.

Without this investment and the significant improvement in our core infrastructure, the sectors might not have been able to manage the effects of the recent drought following two extremely dry winters. And although customers expect the water companies to put increased effort into tackling leakage in times of drought, the resilience of the infrastructure is significantly better than it was in 1976, when we last experienced a drought on such a scale. As a result, service to customers has been much less affected.

1.2 The challenges of the future

All players in the sectors recognise that the challenges that lie ahead are different in scale and nature to what has gone before. Climate change, weather volatility and population growth – along with ever-tightening environmental standards and increasingly sophisticated customer expectations – mean we need to find new and more innovative ways of delivering sustainable water and sewerage sectors. And this is against a very real and present backdrop of a difficult economic climate, with some customers struggling to afford bills, and companies needing to continue to attract investment.

One aspect of forecast future climate change is that we are likely to see increased volatility. Unprecedented rainfall in April 2012 following two dry winters is consistent with such a pattern. So were the floods in 2007, when customers in Gloucestershire lost supply entirely because water company assets were not resilient to floods.

1.3 What we need now

The sectors need to plan for the long term. They also need to:

- be flexible enough to innovate;
- come up with new ways of meeting their customers' needs; and
- manage the more changeable environment.

Customer legitimacy is crucial – that is why the companies need to be more responsive in a drought, which requires communal effort to reduce water usage by taking action to cut leakage.

And our regulation needs to change too. While our regulation delivered well on the challenges of the past, it now needs to become more flexible, adaptable and capable of evolving to enable the companies to deliver for their customers, the environment and their owners. This view is supported by the recommendations of David Gray in his independent review into Ofwat and consumer representation in the water sector. And we see other regulators refreshing and adapting their regulatory approaches to meet an ever-changing environment.

We and the companies we regulate – along with their investors, our environmental stakeholders and customers – need to see incremental and staged changes that are based on ever-improving evidence. This is to ensure that the service today's customers receive continues to be maintained and improved. It is also to ensure that future customers inherit an innovative, sustainable and fit-for-purpose service.

Those changes are needed to focus the sectors on what their customers want and need – and to remove the dependency on the regulatory framework to drive outputs. They are needed to remove unintended bias towards capital expenditure that could lead to unsustainable investment. And they are needed to improve incentives on the sectors to manage our precious water resources in a better, more innovative and sustainable way.

The changes we are introducing need to be seen alongside the many aspects of our regulatory framework that are working well and that we intend to retain. This includes the continued use of core tools like the regulatory capital value (RCV) for calculating revenues and returns.

1.4 The future price limits framework

This document marks an important milestone in a very wide-ranging conversation we have been engaged in for more than two years about how we can play our part by delivering innovative, sustainable and flexible regulation. It sets out the high-level principles we will use to guide the continued development of our key regulatory tool – the price setting process – in a way that will allow us to play the most effective role we can in delivering sustainable water and sewerage sectors.

It is one part of a bigger picture – one that comprises the statutory framework set in legislation, in particular our primary duties to protect consumers and ensure that efficient companies can finance their functions. It includes recent far-reaching policy decisions set out in the UK Government's Water White Paper – 'Water for Life' – along with a future water strategy expected from the Welsh Government.

The work we set out in 'Delivering sustainable water – Ofwat's strategy' and other elements of our future regulation programme are also important. This includes:

- adopting a risk-based approach to compliance as described in 'Delivering proportionate and targeted regulation – Ofwat's risk-based approach'; and
- our new consumer engagement framework for setting price limits, which we set out in 'Involving customers in price setting – Ofwat's customer engagement policy statement'.

And the significant engagement and input of our stakeholders has developed and improved the framework described in this document. We would like to thank everyone who has contributed so far. We welcome the help we have had in shaping this document. We also welcome the many offers we have had of further engagement as we develop the detailed policies and tools for the price setting framework between now and the autumn, when we will consult on our proposed methodology for the next price review.

Appendix 2 summarises the many responses to this stage of the consultation and describes how they have influenced our principles and framework. The accompanying document, 'From principles to price setting – next steps', also picks up on many of the responses and explains the work we will do between now and when we publish our methodology consultation in the autumn to address many of the questions in those responses. It shows how stakeholders can continue to be involved in and influence our work.

1.5 Next steps

We invite all players – companies, customers, policy makers, investors, and environmental bodies – to work with us as we seek to play our part in delivering a collective vision of sustainable water.

We want to build on and improve the trusted regulatory framework for the sectors by ensuring it is robust and adaptable to the challenges of the future. In that way, we will play our part in enabling the sectors themselves to be robust, adaptable and innovative in the face of the challenges they must meet.

2. Background

Before describing the principles we will adopt when we set price limits, it is important to recognise that they sit within a wider framework that governs how we regulate.

2.1 Statutory duties

Ofwat is an economic regulator established by primary legislation. We have a series of primary and secondary duties that are the main drivers of how we regulate. These include our primary duties to:

- protect consumers, wherever possible by promoting competition; and
- ensure that efficient companies can finance their functions.

Our secondary duties include the need to contribute to sustainable development.

2.2 Government policy

As well as our statutory duties, we work within a policy framework set by Government. This ranges from the better regulation principles that guide all economic regulators, to the specific social and environmental guidance given to Ofwat by both the UK and Welsh Governments.

More recently, the Water White Paper set out the UK Government's long-term vision for the water and sewerage sectors in England, and proposed introducing a new strategic policy statement, as well as revising the social and environmental guidance to Ofwat. The Welsh Government intends to issue a water strategy later in the year. The Water White Paper in particular responds to a wide range of reviews of the sectors over recent years – including the Cave review of competition and innovation, the Walker review of charging for household water and sewerage services, and the Gray review of Ofwat and consumer representation.

In setting out our future price limits principles and framework, we have had regard to this context and ensured that our approach is consistent with the wider policy landscape. More than that, our principles and framework are designed to further Government policy objectives by ensuring that we regulate in a way that supports and underpins those objectives.

2.3 Ofwat's strategy

Our future price limits principles also sit within our overarching strategy of sustainable water, which the Ofwat Board reaffirmed earlier this year. The Board continues to keep this strategy under review and considers it remains appropriate – both in relation to the challenges the sectors face, and in supporting the delivery of our primary duties and Government policy, particularly as articulated in the Water White Paper.

2.4 Our future regulation programme

Finally, the principles we apply to setting price limits are influenced by and congruent with the other elements of our future regulation work programme, including our revised risk-based approach to compliance and our approach to customer engagement in the price setting process. We have also taken account of joint work we carried out with the Office of Fair Trading (OFT) in the anaerobic digestion market. This is described in more detail in 'Organic Waste – an OFT market study'. And in line with better regulation principles, we will seek to withdraw or reduce regulation wherever appropriate.

3. Our future price limits principles

3.1 Targeted price controls

We will target our price control regulation appropriately, including:

- **using appropriate tools for different parts of the businesses where the economic characteristics of those businesses are different;**
- **focusing incentives carefully to deliver desired outcomes; and**
- **reducing or removing regulation where it becomes unnecessary over time.**

Applying this principle, for example, leads us to the conclusion that it is appropriate to regulate the retail and wholesale parts of the water and sewerage sectors differently. It also leads us to the view that where water markets are or may become contestable, we should regulate differently from where customers have no current prospect of choice. And where markets are working effectively, we should reduce or remove our regulation entirely.

3.2 Proportionate price setting

We will use our risk-based approach to compliance to ensure that we focus our regulation where it matters and reduce any unnecessary burdens.

This principle underpins our intention to take a risk-based approach to evaluating company business plans. So, where a company submits a well-evidenced plan – including evidence of effective customer engagement – along with full compliance with environmental obligations, we intend to take a less detailed approach to our challenge of that plan. It also simplifies the business plan submission process as it removes the need for draft business plans.

3.3 Effective incentives

We will develop clearer, simpler and more effective incentives that drive allocative, dynamic and productive efficiency in the sectors.

This principle drives our approach to minimise the number of extra incentives that operate outside the core price control, along with our proposals to introduce new incentives to encourage efficient water trading.

It also informs our approach to setting outcomes, assessing costs and monitoring performance in a way that gives the companies more freedom to innovate in how they deliver.

And this principle drives us to continue to set incentives for efficient investment into the sectors by allocating the RCV to the wholesale control, for example. It also reaffirms our commitment to protect all existing RCV and to continue using the RCV in future. And we intend to continue to index the RCV as one of our key regulatory tools in the long term.

3.4 Ownership, accountability and innovation

We will set price controls in a way that gives companies ownership of and accountability for delivery of what customers want and need.

This principle drives our approach of asking the companies to set their own high-level outcomes in consultation with their customers. This will give customers a much stronger voice in the process. And it greatly increases the opportunity for good companies to innovate in how they deliver – giving them greater scope for outperformance and driving dynamic improvements.

3.5 Flexibility and responsiveness

We will design and use our regulatory tools in a way that is future proof and capable of adapting to support the sectors in delivering sustainable water and sewerage services as the environmental and other challenges change over time.

Along with our first principle, this leads us to regulate the retail market differently where there is likely to be choice for customers as described in the Water White Paper. Also, in line with our second principle, it allows us to be proportionate and withdraw or reduce regulation where markets begin to operate effectively.

3.6 Transparency and predictability

We will continue to regulate in a way that is transparent and predictable, and changes we make to the regulatory framework will be based on clear evidence and subject to consultation with all stakeholders.

This principle underpins the commitments we make in our framework to maintaining many of the key aspects of it that are effective and valued by many parties, including investors. It also drives the extensive engagement process we will continue to use to help inform our decisions, and to communicate those decisions and the reasons for them.

4 Our future price limits framework

This chapter summarises the framework we propose using to set price limits in the future. It has been informed by:

- our statutory duties;
- the wider policy framework;
- the principles we set out in chapter 3; and
- the extensive input from our stakeholders.

In the following chapters, we take each element of the framework and describe:

- why we have adopted it;
- what benefits we consider it delivers; and
- how it addresses deficiencies in the existing way we regulate as identified through our extensive consultation, or meets some of the new and significant challenges the sectors face.

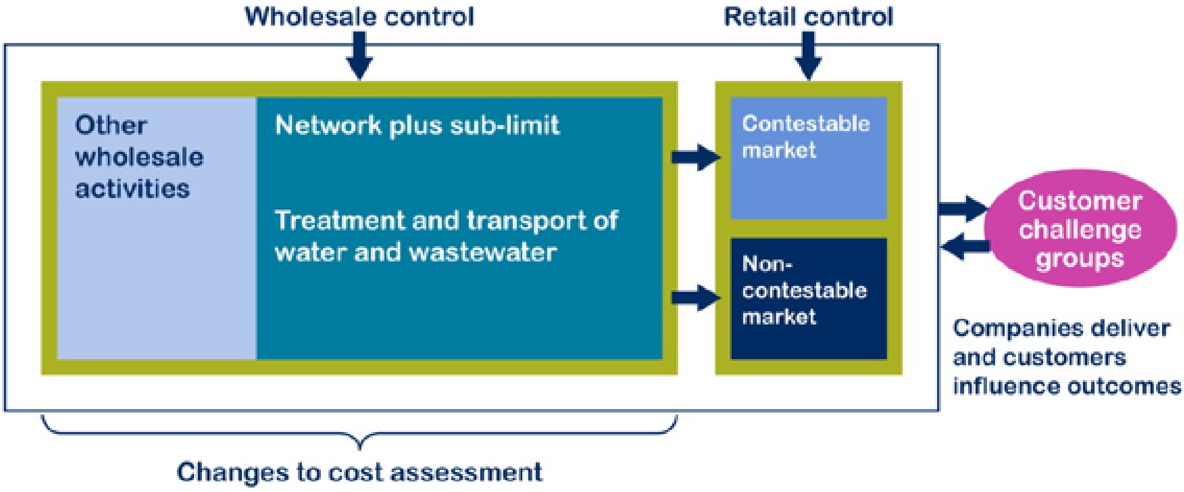
We also summarise relevant stakeholders' views on each of these aspects. Appendix 2 sets out the responses to the consultation in more detail.

We are very conscious of the feedback from stakeholders that there is a need to ensure that we have regard to the practicality of implementing the framework as we develop it and the more detailed policies within it. So, as we describe the various elements of the framework, we identify those aspects that we currently think can and should be implemented for the next price review.

And we flag those elements where we will do more work with stakeholders over the summer to decide whether they can or should be implemented in full for the next price review, or whether they should be staged over more than one price review period.

The richness of responses in this area has led us to publish our next steps document, which accompanies this statement of principles. It sets out the key areas where we are doing more work that will address, among other things, the feedback we received from stakeholders. It also sets out how stakeholders will be able to be involved in and contribute to our thinking. That work will influence our methodology consultation in the autumn.

4.1 The framework



While the framework is expected to operate in a holistic way, for ease of presentation we describe it under the following three headings.

- Elements applying to the overall price setting process.
- Those aspects applying primarily or only to the wholesale control.
- Those aspects applying primarily or only to the retail control.

4.2 Elements applying to the overall price setting process

We intend to require the companies to propose in their business plans the **outcomes** they will deliver. In line with our customer engagement policy statement, they should develop these in consultation with their customers and stakeholders.

As outcomes are likely to be longer lived than outputs, companies will propose the **milestones and measures** that we will then use to monitor progress in delivery.

Where companies develop well-evidenced outcomes with supporting evidence of effective customer engagement (along with a range of other characteristics), we intend – in line with our risk-based approach – to apply **less intensive scrutiny** during the price review process, reducing the process burden where appropriate.

We will consider further whether companies will be required to propose a **delivery incentive mechanism** that will come into effect if a company fails to deliver an outcome.

We intend to set **two types of price control** – wholesale and retail. This will allow us to use different approaches in each area, tailored to the:

- nature of the business;
- economic characteristics of the activities carried out by that business – for example, the degree of contestability or not; and
- types of behaviour that we want to incentivise in each area.

We are currently consulting on making appropriate amendments to company licences to enable us to set separate price controls (and to make other changes such as varying the duration of the controls in the future if that is appropriate). The outcome of that consultation and licence amendment process may influence the final nature of the separate price controls. We published further detail in:

- 'Water Industry Act 1991, section 13 proposals by Ofwat to modify the conditions of appointment of all water only and water and sewerage companies'; and
- IN 12/04, 'Responses and next steps on the consultation on proposals to modify the conditions of appointment of all water and sewerage and water only companies'.

We will set the wholesale and retail controls for a period of **five years** from April 2015. The above documents consider the case for flexibility in company licences to potentially alter this duration in future price controls.

We will simplify the process of setting price limits and seek to reduce the burden on all players by using our **risk-based approach** as outlined earlier. And we will reduce the stages in the process by:

- removing the requirement on the companies to submit draft business plans; and
- allowing more time after our draft determinations for companies to make representations, including time for them to consult again with their customers.

We will continue to use a 'dual till' approach for the treatment of **regulated and unregulated activities**, as we do now. This means that revenues generated by unregulated activities will not be taken into account when setting prices for regulated activities.

4.3 Elements applying to the wholesale control

We will regulate the wholesale business using many of the existing tools and mechanisms that are tried and tested in the price setting process.

Given the asset-intensive nature of the wholesale business, we will allocate the existing **RCV** to the wholesale control. We have made it clear that all existing assets that are efficiently incurred within the current price control period will remain in the RCV. We also confirm that we intend to continue using the RCV when setting wholesale price controls in the future.

When we next set price limits, we intend to index the RCV to **RPI**. And we intend to continue using indexation of the RCV as one of our key regulatory tools in the long term. When we have consulted previously on changing the relevant index, we have concluded that RPI still remains the most appropriate index to use. We would only consider changing this approach if there was clear evidence to do so, and in accordance with our statutory duties.

Other familiar risk management tools that we will continue to employ include (but are not limited to) **interim determinations** and the **substantial effect clause**.

We intend to change our approach to cost assessment and cost recovery. We propose treating capital expenditure (capex) and operating expenditure (opex) together – a total costs or **totex** approach. We also propose using some element of a **menu** as we currently do for capex through the capital expenditure (capex) incentive scheme (CIS).

We intend to introduce new incentives into the wholesale control to incentivise the companies to **manage water resources** more efficiently (allocative efficiency). When coupled with other elements of the framework – like setting outcomes rather than outputs, and taking a totex approach – these incentives will encourage companies to find more innovative ways of delivering, increasing the opportunity for outperformance from such innovation.

These comprise incentives to:

- increase **water trading**;
- abstract water from the most environmentally positive sources and to reduce unsustainable over-abstraction (the **abstraction incentive mechanism – or AIM**); and

- **optimise company networks** to facilitate the better allocation and management of our precious water resources, including through better interconnection and water transfers.

We will ensure an orderly transition and management of legacy incentive mechanisms. This includes mechanisms (such as the CIS) that may be subsumed into others, and those that we intend to retain (such as the **revenue correction mechanism**).

We intend to develop a sub-limit within the price control that will apply to the network and treatment assets – the **network plus control**. As this is a long-term ambition within the framework, we expect the first implementation of this sub-limit to be non-binding and to focus primarily on revealing information that will help us to develop this regulatory tool over time.

We have considered introducing a sub-limit on the **sludge treatment and disposal business** in response to the joint work we did with the OFT on the anaerobic digestion market. But we have decided that this would not be proportionate at this stage.

4.4 Elements applying to the retail control

We intend to regulate the water companies' retail business differently depending on whether the business is serving customers that have – or are likely to have – choice of supplier (the contestable market) or not (the non-contestable market).

In line with Government policy, the contestable market will comprise all non-household customers of English water companies when legislation that implements the commitments from the Water White Paper is introduced and enacted. Pending the Welsh Government's water strategy later this year, we currently expect the contestable market in Wales to comprise customers of Welsh water companies that use more than 50 million litres (or megalitres – Ml) of water a year.

In the contestable market, we intend to regulate using **default tariffs and default service levels**. This will allow us to reduce our current detailed regulation of all prices to all customers in this market, and so remove a regulatory burden on the companies. It will provide protection to customers while at the same time allowing retailers to offer innovative and new tariffs and services.

In the non-contestable market, we intend to regulate using an **average cost to serve** as a proxy for the costs of an efficient retailer. We expect our approach to evolve over time as we learn more about true efficient costs.

We will continue to use the **service incentive mechanism (SIM)**, in particular for the non-contestable market. We will adapt it to take into account the existence of two separate retail controls.

5. Elements applying to the overall price setting process

In this chapter, we expand on the elements of the framework that apply to the entire price setting process. We explain why we have adopted each element of the framework and what it is expected to deliver. We also summarise stakeholders' views on each element at a high level only. And we note whether there is further detailed work to be carried out on each element. Where this is the case, we describe how that work will be carried out – and the opportunities stakeholders will have to engage with and influence it – in the next steps document that we have published alongside this statement of principles.

5.1 Setting outcomes

5.1.1 What is it?

A key element of the new framework is that companies will develop and propose in their business plans the outcomes they will deliver rather than the outputs. Outcomes are likely to be longer lived than the current outputs, which are generally restricted to the five-year price control period.

Because outcomes may span more than one price control period, we will require companies to propose the milestones and measures that should be used to monitor progress in delivering these outcomes. And we are continuing to explore if the companies should propose delivery incentives that would come into effect if they fail to deliver a particular outcome.

The companies will set outcomes through a process of consultation and engagement with customers and stakeholders. We describe this in more detail in section 5.3 below.

5.1.2 Why do it?

This approach has a number of advantages, which are enhanced when they are considered alongside other elements of the framework.

First, by giving the companies responsibility and accountability for setting outcomes they should become less dependent on the regulatory framework to determine deliverables. This places decisions clearly with those that are best placed to take them, and should lead to better results for companies, the environment and customers.

Second, by setting longer-term outcomes rather than short-term outputs, the companies will be incentivised to plan for the longer term. This is one of our goals and also one of the ambitions of the Water White Paper because of the benefits it can deliver.

Third, by holding the companies to account for delivering their outcomes rather than more detailed inputs or outputs, we will give them significantly more freedom to innovate and improve **how** they do this. If they find innovative ways of delivering outcomes and achieve significant savings, they will benefit from keeping this outperformance. When combined with a totex approach – which will enable companies to choose between the types of solution they use without fear of preferential treatment of one type of expenditure over the other – the scope for outperformance is even greater.

Fourth, by monitoring compliance with outcome delivery (including through monitoring milestones if appropriate), we expect the regulatory burden on Ofwat and the companies to reduce considerably. There are more than 11,000 schemes comprising about 2,000 ‘outputs’ in the current price control period and delivery of these will have to be measured at the end of the period. We expect there to be a greatly reduced number of compliance measures in the next price review period under an outcomes approach.

Crucially, when combined with the other elements of the framework this approach gives the companies greater scope to **innovate** and find more sustainable solutions. Those that do this will outperform. And because the scope for outperformance is greater, so too are the rewards for those companies that succeed.

But customers still need protection. So, if a company does not deliver the required outcome, it will need to carry out whatever additional expenditure or outlay is needed to rectify this at no added cost to customers. This is a characteristic of the current regulatory framework. But we are concerned that for those companies that do not perform well, this incentive not to fail may not be sufficiently strong.

So, we are continuing to explore the potential for a delivery incentive mechanism, which the companies would propose as part of their business plans. These incentives would comprise ‘pledges’ of what the companies would do if they failed to deliver a particular outcome.

5.1.3 What stakeholders say

Stakeholders that responded on this point welcomed an outcomes approach. For example, environmental stakeholders welcomed the scope for improved and more sustainable results, particularly when combined with a totex approach to cost assessment and cost recovery. In general, the companies welcomed the opportunities to innovate and outperform. And consumer representatives welcomed the focus on customers that will come from this change.

Understandably, stakeholders wanted more detail on how we will measure outcomes, particularly to apply rewards or penalties. And many companies expressed reservations about the proposed delivery incentive mechanisms. Their main concern was that these should be symmetrical – that is, the companies should earn greater rewards if they over-deliver on outcomes. We do not think additional rewards are appropriate.

This is because if a company delivers more of an output than customers have expressed a willingness to pay for, then it would appear inappropriate that customers pay more for the thing they stated they did not want. But we want to explore respondents’ comments further before finalising our view. It may also be that this ‘over-delivery’ was not the result of companies’ actions – it may be because of benign conditions (for example, mild winters).

5.1.4 Next steps

The companies and their customer challenge groups (see section 5.2 below) are already working to set outcomes. We welcome and will continue to be engaged in this work, which will also help define measures and milestones.

We will carry out further work on outcomes. This will focus in particular on the delivery incentive mechanism and will inform our methodology consultation in the autumn. The next steps document discusses this in more detail.

5.2 Customer engagement

5.2.1 What is it?

We have already published our approach to customer engagement during and after the next price review. We developed this approach following extensive consultation. It aims to:

- give customers a greater say in the development of business plans;
- improve the companies' engagement with and responsiveness to their customers; and
- enhance legitimacy with customers.

In brief, we have required the companies to engage directly with their customers when setting their outcomes. We have asked them to set up customer challenge groups. These groups will challenge the companies on the quality of their customer engagement and the degree to which that engagement has influenced the business plan that we receive. The customer challenge groups have independent Chairs, and will report to us alongside the business plans that companies submit. We have also set up our own customer advisory panel to engage with us as we develop sector-wide aspects of the price control.

More detail is available in our decision documents and in IN 12/05, 'Involving customers in price setting – Ofwat's customer engagement policy: further information'. We are pleased to see that there has been considerable progress on this issue – with many companies having already established their customer challenge groups. And we have already held an initial meeting with our customer advisory panel. The notes of this meeting are available on our website.

5.2.2 Why do it?

Enhancing customer engagement delivers a wide range of benefits, particularly when combined with other elements of the framework.

First, by focusing the companies on what their customers want and need – rather than on the regulatory targets we set – we consider that better outcomes will be devised. And because this approach places responsibility with the companies, we think this will reduce the culture of dependence that David Gray mentioned in his independent review of Ofwat and consumer representation. It will also create more dynamic, customer-focused businesses. Such businesses are much more likely to **innovate** to succeed in the future.

Second, by improving customer engagement in the process, we expect the **legitimacy** of the final business plans and the bills customers pay to be enhanced. At a time when many customers are finding it difficult to pay their bills, this is becoming ever more critical. The lack of understanding that customers have is clearly evidenced in their current confusion over why they face usage restrictions in times of heavy rain and flooding. And customers are strongly critical of their company's performance on managing leakage. The companies need to be more responsive to this type of feedback.

5.2.3 What stakeholders say

Interested parties made their detailed comments on this approach during the consultation we held in April 2011. We reflected these comments in our customer engagement policy statement, which we published in August 2011. Since then, support for greater customer engagement has continued and the companies are delivering practical first steps to develop the approach.

Consumer bodies also re-iterated their support for greater customer engagement.

As this work has progressed, various stakeholders – including the Chairs of the customer challenge groups – have raised a number of helpful queries about the detailed operation of the engagement process. We are addressing these issues as part of our ongoing work.

5.2.4 Next steps

We are pleased that all parties are taking this work forward constructively. For our part, we have:

- held a workshop for the Chairs of the customer challenge groups;
- published a further information notice; and
- started to develop more detailed guidance on which we will consult in the summer.

5.3 Setting separate price controls

5.3.1 What is it?

One of the key principles guiding our work is that we should target our regulation on the various activities we regulate according to the characteristics of the activity concerned. Having consulted extensively, we have concluded that we should set price controls for two distinctly separate and different activities within the water and sewerage businesses – wholesale and retail.

While we have also proposed further targeting of incentives within these controls, we consider that the two types of activity are so distinct that by setting separate controls we would create the greatest incentive on the retail businesses in particular to have a greater customer focus.

Setting separate wholesale and retail price controls is a tried and tested approach to regulating utility sectors in the UK. How we implement this element of the framework will depend on the outcome of our current consultation on proposals to amend company licences.

5.3.2 Why do it?

At present, the asset-intensive network and treatment businesses comprise 95% of the water and sewerage value chain. As a result, it is not surprising that the companies' focus is on this aspect of the business.

Creating a separate retail control would focus retail businesses sharply on their customers. It would also mean that our incentives on this part of the business could be more effective, and less likely to be swamped by the interests of the wholesale business.

And in serving the interests of retail customers, the retailer would be able to place efficiency pressures on the wholesale business.

Finally, introducing contestability in water and sewerage services to non-household customers (a significant part of the retail market) means that setting separate wholesale and retail price controls is likely to be the most effective way to regulate. This is a commitment in the Water White Paper. Separate controls are particularly important because the UK Government has decided not to require legal separation of incumbent water company retail businesses. If companies remain vertically integrated, then retail price controls will be essential to police non-discrimination in the market.

5.3.3 What stakeholders say

Most stakeholders accept the need for separate price controls – some recognised explicitly the benefits of our proposals. A number of incumbent water companies considered that only the potentially contestable part of the retail business should have a separate control. Many respondents raised detailed concerns about how the controls would work. We agree that, in general, these are useful and relevant queries that we have yet to address.

Some stakeholders noted that customers in the non-contestable market should not cross-subsidise customers in the contestable market, in particular by bearing the costs of introducing competition. We can confirm that we will ensure no undue or unfair cross-subsidisation takes place as a result of our intention to set separate price controls.

We consider that even where they do not have choice, customers can benefit from a separate retail control. This is because it will deliver the customer-focused incentives whether or not the market is contestable. The companies should be incentivised to deliver for all their customers. Arguably, this is even more important where those customers have no choice.

5.3.4 Next steps

To set separate price controls we need to amend the companies' licences. This is because those licences currently provide for only one price control. We have consulted on a proposed amendment, but the companies rejected this. So, we have extended the period of engagement to consider how best to resolve this issue. There is more detail on this in IN 12/04. The final form of any licence amendment will influence our final approach.

It will also be necessary to define the boundary between the two price controls. We are taking this forward through our work on the definition of the retail business, which we discuss in chapter 7.

5.4 Setting the duration of the price controls

5.4.1 What is it?

Traditionally, we have set price controls for a five-year period. The companies' licences allow for this. In line with our principle about targeting our incentives through distinct price controls, we consulted on the incentive properties of different price control durations for the very different wholesale and retail businesses.

Having considered this issue and the responses we received further, we have decided to set both the wholesale and retail controls for five years when we next set price limits. But as we and the sectors learn from the new controls, we would wish to revisit and consult on this before we set price limits again.

5.4.2 Why do it?

Given the different nature of the wholesale and retail business, it might be appropriate to set price limits for different durations. For example, given the long-term nature of the asset-intensive wholesale business, it might deliver greater certainty to investors if we set price controls for a longer duration. But this certainty could be offset by concerns of intervention during the period.

It might be appropriate to set shorter price controls in the retail sector – for the contestable part of the market in particular – but also potentially for the non-contestable part of the market. As we learn more from having distinct and separate controls, retail businesses are likely to find new ways of doing things. So, we would want to ensure that any control did not stifle innovation with inappropriate rules. As a result, we might want to adjust this more often.

But given that this is the first time that distinct controls will have been set, and that we all have to learn from the information that will be revealed through this process, setting the controls for five years will minimise the number of changes we are making at one time. This will reduce the amount of new issues companies have to deal with.

This is an example of where we consider a change to duration should not apply to the next price control, but could be considered again for subsequent price reviews.

5.4.3 What stakeholders say

Of the stakeholders that commented, most were in favour of retaining the five-year price control period for both wholesale and retail at this stage. Some were open to revisiting the issue again in the future.

Other respondents suggested the control period could be aligned to the six-year river basin management plans and the Water Framework Directive.

5.4.4 Next steps

While we intend to set wholesale and retail controls for five years when we next set price limits, we want to learn from the experience. So, we intend to consult with the sectors before we set subsequent price limits as to whether that learning suggests we should alter durations in the future.

To bring this about, we are seeking enabling modifications to the companies' licences that would allow us to vary the duration of the control in future. As we discussed earlier, the amendments we are proposing are subject to an extended engagement process at present.

5.5 Treatment of unregulated businesses

5.5.1 What is it?

Companies may engage in activities outside the regulated licensed business they are required to provide. When this is the case, we need to specify how we will treat revenues a company earns from that unregulated activity.

We intend to continue to use a **dual till** approach for the treatment of regulated and unregulated services. This is the approach we currently use. It means that revenues generated by unregulated services will not be taken into account when we set price limits for regulated services.

5.5.2 Why do it?

The companies should be free to innovate and operate in unregulated areas where this does not impact adversely on the regulated business or its customers. We considered a range of options from a risk and profit sharing approach to a single till approach. But we concluded that, at this time, none of these options offered material benefits in return for the potential cost of introducing and monitoring a new mechanism.

We consider it best to retain the existing mechanism at this stage because it is well understood and protects consumers.

5.5.3 What stakeholders said

We received very few responses to this issue. Most that did respond were in favour of keeping the status quo.

5.5.4 Next steps

We will incorporate this approach into our methodology consultation.

6. The wholesale control

The elements set out in chapter 5 will all apply to the wholesale control, including:

- customer engagement;
- setting outcomes; and
- the duration of the control.

In this chapter, we describe the wholesale control in more detail. Given that much of this control will be familiar as it will be based on the existing price control tools, we concentrate on those aspects that will be different. But we do give a high-level summary of those things that will not change.

6.1 Regulating the asset-intensive business – retaining what works

6.1.1 What is it?

We intend to set a wholesale price control that will include indicative separate price limits for water and sewerage as we do now. To set this price control, we will use many of our existing regulatory tools because these have been designed for an asset-intensive business and have many positive incentive properties that we wish to retain.

First, we will allocate the existing **RCV** to the wholesale control. We have made it clear that all existing assets that are within the current price control period will remain in the RCV. We also confirm that in our framework we intend to continue to use the RCV when setting wholesale prices in the future.

We intend to index the relevant RCV to **RPI** when we next set price limits. We intend to continue to index the RCV as one of our key regulatory tools in the long term. We have consulted in the past on changing the relevant index. Based on clear evidence, we have concluded that RPI remains the most appropriate index. This evidence includes the wider macroeconomic use of RPI and the fact that index-linked debt is also generally linked to RPI. We will base any further consideration of this issue in the future on clear evidence and in accordance with our statutory duties.

Other familiar risk management tools that we will continue to employ include (but are not limited to):

- **interim determinations**, where we can revisit price limits in specified circumstances, including where new obligations are placed on companies; and
- the **substantial effect clause**, which allows companies to seek alterations to price limits when circumstances outside their control has a material effect on their ability to finance their functions.

We also intend to retain some existing incentives, including the **revenue correction mechanism**, which we will adjust to apply to the wholesale business. This mechanism removes the incentive on companies to seek to sell more water to increase revenue. It also acts as a risk mitigant, protecting companies from revenue volatility.

We will manage legacy issues carefully as we make the transition to any new incentive mechanism. These include logging up and down, and any adjustments arising from the CIS.

6.1.2 Why do it?

We are retaining these tools – they have been proven to be valuable, particularly to investors who are interested in investing in long-term, stable industries. They are key aspects of our regulatory framework, and because of this companies in the sectors receive better credit ratings than they would otherwise. In turn, this ensures that they can access the capital they need to invest at a cost that is lower than it would be otherwise.

This is an aspect of the regulatory framework that we want to maintain now and over the long term. While keeping these aspects of the framework, we also want to adjust others so that the valuable investment from the debt and equity markets is spent on the right assets for sustainable sectors in the long term. This will be in the interests of investors, as well as customers and environmental stakeholders.

6.1.3 What stakeholders say

Stakeholders have commented on the stability of these aspects of the framework throughout our consultation. In general, investors, companies and Government have welcomed our approach.

We recognise that while welcoming this, some stakeholders considered that some of our other changes were creating uncertainty. We address these comments in the following sections.

6.1.4 Next steps

We will continue to develop the detail of these aspects of the framework and include them in our methodology consultation.

6.2 Capex, opex and totex

6.2.1 What is it?

While we were reviewing our price setting tools, many stakeholders told us that the way we treat capex and opex separately has become complex and burdensome. We have also heard that our approach may create perverse incentives, ranging from a bias towards capex to a rigid, technical and inflexible approach from companies that are driven by the detailed mechanisms we use. Others have perceived that our overall approach may encourage ‘gaming’ or ‘padding’ of business plans by companies that may consider it in their interest to inflate costs in their original submission.

So, we have consulted on – and propose to change – our approach. Within our wholesale control, we intend to move to an approach that:

- treats capex and opex together (a totex approach), to equalise the incentives between the two; and
- uses a menu approach similar to that used for capex in the last price review (the CIS).

This would allow companies more choice in the level of risk they want to take and the accompanying potential for outperformance. It would also create a better incentive for companies to reveal true investment needs in their business plans, thus reducing the incentive to game the process.

We consulted on a range of possible approaches to deliver this and recognise the clear need for more work before the precise detail of a totex approach with menus might work. So, while we consider this to be a part of our long-term framework, there are still significant decisions to be made on which elements should be adopted at the next price review, and whether some aspects should be phased in over more than one price review.

6.2.2 Why do it?

We acknowledge the shortcomings to our past approach and agree that it needs to change. We consider the totex and menu approach has a number of advantages.

First, when combined with our approach to outcomes and customer engagement, it creates much more scope for the companies to **innovate and outperform**. This is because they can make choices about which type of expenditure to incur (capex or opex) based on the best outcome, rather than on the regulatory mechanism that dictates the return they will get. So, they will not be tempted to adopt a capex solution just because it will go on the RCV and earn a return, for example, where an opex solution might have delivered better results, but which under our old approach may have been perceived as increasing opex (and so indicate inefficiency).

Second, instead of a web of complex incentive mechanisms as we currently have (with not only different treatment of capex and opex, but also different treatment of above- and below-ground assets) we should have a simpler, unified incentive that drives the companies to make better choices. This should **reduce the burden** of administering and managing the price control and companies' businesses.

Third, using a menu approach would complement the use of totex. This is because it gives the companies a financial incentive to reveal true costs, avoiding padding of business plans and aligning their returns with their risk appetite. That aligns with our other proposals in that it places these choices with the companies rather than with the regulator. This creates **greater scope for outperformance** by the better-performing companies that are good at managing their business risks.

6.2.3 What stakeholders say

Some stakeholders, including environmental organisations and the supply chain (contractors and suppliers), were clear in their support for our totex approach and the benefits it can deliver. While some of the companies expressed limited support, many opposed the approach on the basis of potential complexity and a lack of understanding of the likely impacts of a change.

These respondents had many relevant questions on the detail of how totex and menus would work in practise. We accept many of the concerns expressed about the detail of developing a fully functioning totex and menu approach in time for the next price review.

6.2.3 Next steps

In the light of the detailed responses and valid issues that the companies raised on how a totex and menu approach might work, we are pleased that collaborative work is already under way to develop this detail. This includes work that UKWIR, the UK water industry research body is carrying out.

Our next steps document sets out in more detail the additional work we will do before we consult on our methodology in the autumn.

6.3 Incentives to trade water

6.3.1 What is it?

To improve the way we manage our scarce resources, we proposed a range of new incentives that we could introduce to encourage the companies to trade water where that delivers the best solution to their water resource management challenges.

Some of the changes already described – including our approach to outcomes and totex – should help to meet this objective. This is because they remove potential disincentives to effective water trading. For example, by removing any bias towards capex solutions, a totex approach could make purchasing water a more attractive option for a company with a water resource deficit when compared with the cost of developing a new resource.

But we consider that we should go further and introduce positive incentives in this area. The mechanisms we proposed are not mutually exclusive and all received varying degrees of support. We consider that the best incentive package is likely to comprise a mix of these mechanisms. So, we intend our long-term framework to have an appropriate mix of incentives. These could include:

- deregulating bulk water trading;
- increased returns for water importers and exporters of water across company boundaries; and
- stronger obligations on the companies to consider imports when planning how they will manage resources through the water resource management planning process.

6.3.2 Why do it?

Our duties, Government policy (through the Natural Environment White Paper and the Water White Paper), our strategy and the future price limits principles set out in this document all recognise the importance of ensuring the sectors have the incentives to manage our precious water resources in an environmentally, socially and economically sustainable way. This is crucial to the future success of the sectors. More water transfers will increase resilience and deliver more flexible options for companies to meet short-term deficits – for example, those caused by drought.

And there may be potential for longer-term trades and transfers from areas where water is plentiful and abstracting it from the environment is not damaging that would help serve areas with water scarcity and high population density.

6.3.3 What stakeholders say

Environmental stakeholders all supported this element of the framework. One stakeholder was concerned that incentives should not lead to higher bills for customers than would otherwise be the case.

In general, the companies supported the principle, but had a range of questions on how the incentives might be structured.

6.3.4 Next steps

We will address the degree to which our approach to totex will deliver incentives for water trading or remove disincentives in the work we have already identified on this issue. We will take work forward to develop the detail of the other options either with a view to delivering proposals in our methodology consultation, or as part of joint work with the Environment Agency, Defra and the Welsh Government. Our next steps document sets this out in more detail.

6.4 Incentives to abstract water sustainably

6.4.1 What is it?

When we considered improving incentives to trade water, we identified the potential for this to create a perverse incentive – a company with a licence to abstract water might be tempted to use that abstraction even if it were environmentally damaging, in order to sell water. So, we proposed introducing the abstraction incentive mechanism (AIM) to identify where and when abstraction could be most damaging, and to disincentivise it, making it less likely or frequent.

We propose including this incentive in our framework in the short to medium term. This is to ensure that our water trading incentives do not unintentionally incentivise an increase in unsustainable abstractions. As the reforms to the abstraction framework as set out in the Water White Paper are implemented, the need for this mechanism should fall away.

6.4.2 Why do it?

The Water White Paper has identified the need to reform the abstraction licensing framework. It notes that the current framework is outdated. As a result, both over-licensing and damaging over-abstraction exist. When appropriate reforms are made to ensure a sustainable level of abstraction, we do not think the AIM would be necessary. But until then, we consider this safeguard incentive mechanism will be important to correct against any perverse incentive to over-abstract.

6.4.3 What stakeholders say

Once again, environmental and other stakeholders supported this incentive. Understandably, the companies asked for more detail on how the AIM might work in practise. We recognise the need to develop more of the detail before we consult on our price review methodology.

6.4.4 Next steps

We will work with the Environment Agency to develop the details of the AIM and consult on this over the summer. This will inform our methodology consultation. Our next steps document contains more detail on this.

6.5 Incentives to optimise water networks

6.5.1 What is it?

As we seek to incentivise more water trading and transfers, the companies will need to manage their networks in a way that facilitates and enables the best choice of such transfers and trades, along with the use of existing sources of water. We describe this function as ‘network optimisation’.

We propose that the companies should be incentivised to focus on this function. This is because it will be essential that networks are optimised and managed in a way that makes efficient water transfers possible. Without that, the effectiveness of water trading in delivering the best resource management solutions will be diminished.

We consider that network optimisation incentives should form part of our future price limits framework. But we recognise that this will need to develop in parallel with our better understanding of water trading and the implementation of the UK Government’s proposals for new entrants to enter the market.

6.5.2 Why do it?

The management of efficient and effective water networks is likely to become increasingly important over time. This will happen as water trading begins to reveal more opportunities for transfers and interconnections. So, companies need to become more sophisticated in balancing supply and demand – particularly in the short term.

And the importance of this will increase when the UK Government's proposals to allow new parties to sell water into the public supply networks are implemented in the future. The Water White Paper recognises the need for efficient networks to develop to support the efficient allocation of water.

6.5.3 What stakeholders say

Most companies opposed any sort of network optimisation incentive. They argued that as they already carried out this function adequately, it would be difficult to define the function and it would vary from company to company. Those with experience of a centralised network optimisation system were more positive.

Environmental and other stakeholders agreed that there were potential benefits from incentivising network optimisation.

6.5.4 Next steps

We will develop network optimisation incentives that will sit within the wholesale business as part of our long-term framework. We recognise the need to learn from the information that is revealed as our incentives for water trading improve. So, we may need to revisit this in future price control periods. We describe the work we will be doing to develop this incentive in our next steps document. We would very much welcome input from the companies into this work as it goes forward.

6.6 Sub-controls – network plus

6.6.1 What is it?

While we are proposing to set one wholesale price control, we are aware that there are still some distinctly different activities within it. So, we have considered sub-limits to target some specific activities. In particular, we intend to introduce a sub-limit on the network and treatment assets within the network control.

This would include most of the assets currently considered to be part of a traditional incumbent water company's business. Remaining activities would be expected to comprise the water resources activities of the business.

The network plus sub-limit may be more or less binding depending on the reliability and robustness of the information used to set the control. The existence of a control and the exercise of allocating costs and revenues will improve that robustness over time.

6.6.2 Why do it?

First, by separating out the network plus activities we will create greater transparency around the costs of the companies' resources activities. This transparency should support and improve efficient water trading as players have better information on which to base their decisions.

Second, the Water White Paper signals the intention to introduce the possibility of stand-alone retailers obtaining water from stand-alone resource suppliers, through changes to the water supply licensing framework. It also creates the possibility of separate licences for upstream only wastewater suppliers.

Other changes accompanying these proposals include using a future Water Bill to remove the costs principle from legislation and instead introduce a transparent access pricing framework that will require incumbent water companies to produce wholesale charging schemes based on enforceable charging rules issued by Ofwat. The network plus control would be a regulatory tool to help reveal the necessary information to regulate and police those charging rules.

6.6.3 What stakeholders say

All the companies opposed the network plus sub-limit, citing uncertainty over future developments arising from the Water White Paper and arguing that it would be disproportionate.

Other stakeholders, including Government bodies and new entrants, recognised that the sub-limit could deliver value in the evolution of the regulatory framework.

6.6.4 Next steps

We will carry out work over the summer to determine how far we should implement the network plus sub-limit in the next price review, and whether it should be introduced in phases.

6.7 Sub-controls – sludge

6.7.1 What is it?

Following our work with the OFT on the anaerobic digestion market, one suggestion to address concerns about the effectiveness of such a market was the potential for a sub-limit on the sewerage companies' sludge disposal and treatment activities. As with the network plus sub-limit, this would help reveal information on costs and revenues in this specific activity. This would help transparency and has the potential to improve the working of the sludge and anaerobic digestion markets.

6.7.1 Why do it (or not)?

With greater transparency, sewerage or other companies might identify opportunities for innovation and competition in the market for sludge disposal and anaerobic digestion that could lead to a better functioning market.

But our joint work with the OFT identified a number of other aspects of our regulatory framework that could be improved to help this market to function. These seem to be of greater significance, and include:

- removing capex bias by introducing a totex approach; and
- the general increase in opportunity and incentive to innovate, which is delivered by our framework overall.

Given this and the generally small value of the market at this stage, we do not consider it proportionate to introduce a sub-limit for sludge at this time. But we consider it would be worthwhile to explore this further as part of the longer-term framework after the next price review.

6.7.2 What stakeholders say

There was limited interest in a sub-limit. Those that commented – including those in favour – generally accepted that it would be disproportionate to set a sub-limit at this stage when there are many other issues to address. There was some support for exploring this option further after the next price review.

6.7.3 Next steps

We will revisit this issue after the next price review.

7. The retail control

The elements in chapter 5 will apply to the retail controls we propose to set. This chapter describes further elements of our framework that will apply to all of the retail price controls. It then goes on to describe the different elements that will apply to our proposed distinct controls for the retail businesses serving customers that:

- have or expect to have the prospect of choice; and
- are unlikely to have choice in the near term.

We consider that setting separate retail controls would create a sharper focus on customer-facing activities than is currently the case, encouraging a change in behaviour among the companies. It would enable us to target our incentives in a way that could further improve that focus over time. As a customer champion, the retailer would also be able to challenge the wholesale business to improve.

And a separate retail price control is a necessary requirement to deliver real choice to all non-household customers in England as set out in the Water White Paper.

We received a variety of consultation responses on these aspects of our framework. Most respondents, regardless of which stakeholder group they represented, acknowledged the need for separate wholesale and retail controls. But many raised specific concerns about the details of the controls and how we would implement them.

In our next steps document, we set out how we will address these important questions. Among other things, we will carry out a targeted consultation on issues associated with the structure and implementation of the retail controls. This will include the definition of what activities will be included in the retail businesses.

7.1 Targeted and tailored price controls

7.1.1 What is it?

In line with our principle of targeting regulation and ensuring it is proportionate, we intend to regulate the retail business of water companies differently depending on whether the business is serving customers that have or are likely to have choice of supplier (the contestable market) or not (the non-contestable market).

In line with Government policy, the contestable market will comprise all non-household customers of English water companies when legislation that implements the commitments from the Water White Paper is introduced and enacted. Pending the Welsh Government's water strategy later this year, we currently expect the contestable market in Wales to comprise customers of Welsh water companies that use more than 50 million litres (or megalitres – Ml) of water a year.

7.1.2 Why do it?

Taking this approach would allow us to adopt a more flexible approach. It would also allow us to use a more appropriate form of regulation that better reflects the underlying characteristics of these activities. A separate control will provide transparency and certainty. It would also help give non-household customers a choice of suppliers. And we expect it to deliver a wider choice of service and tariff offerings while allowing us to protect those customers that cannot choose.

It would represent a simpler form of control. And in the future, it should also allow us to withdraw or reduce regulation where it is no longer needed.

7.1.3 What stakeholders say

Most stakeholders accepted the need for targeted and tailored controls for the two types of retail services we describe. But some incumbent water companies suggested that the retail control for the non-contestable market should stay combined with the wholesale control. Stakeholders expressed different views on the length of these controls.

Respondents to our consultation raised a number of questions and queries, including how we will treat wholesale costs in each of the retail controls, and how we will define what is included in the retail businesses – for example, where meter ownership will be allocated.

7.1.4 Next steps

We agree with respondents on the need to develop the detail around how we will set retail controls. We have already initiated an informal discussion about the definition of the retail services in 'Defining retail services: a discussion paper', and as we set out in our next steps document, we will consult further on this and other important issues over the summer to inform our methodology consultation in the autumn.

7.2 The non-contestable retail control

7.2.1 What is it?

We intend to regulate the non-contestable market (including all household customers) using an **average cost to serve** as a proxy for the costs of an efficient retailer. We expect our approach to evolve over time as we learn more about true efficient costs.

Companies will need to engage with their customers to understand what outcomes they want them to deliver. We will also continue to use the **SIM**, but we may adapt it to reflect the existence of two separate retail controls (for water and sewerage services) and the interaction with customer engagement and outcomes.

7.2.2 Why do it?

Customers in the non-contestable market continue to have no choice of supplier and no prospect of choice in the future. Given that the incumbent monopoly companies continue to have an exclusive right to supply these customers, it is necessary to continue to protect them using a regulatory approach that challenges companies to be more efficient and effective. Using an average cost to serve approach will focus management attention on retail in a way that the single overall control cannot. This will challenge companies to do more to address growing problems like bad debt, as well as improve levels of customer service.

7.2.3 What stakeholders say

In general, respondents supported the average cost to serve approach for the non-contestable retail control. But they raised a range of issues associated with applying this approach.

For example, they were concerned about how the average cost to serve would be calculated and implemented to avoid price rises without any improvement in service for those companies operating below the average. Consumer representatives were concerned that customers that cannot change supplier should not be disadvantaged. And there were concerns about whether the companies' retail cost information was robust enough for this approach to be effective.

A number of respondents raised indexation as an issue, and there were questions about the impact an average cost to serve approach would have on the incentives on companies to carry out activities like metering and water efficiency advice. Finally, companies and investors asked whether and how adjustments should be made to the average to reflect local circumstances outside of companies' control, such as levels of local deprivation.

7.2.4 Next steps

We recognise that stakeholders have raised some important points. We intend to consult on these issues over the summer and carry out further work to inform our methodology consultation. More detail is available in our next steps document.

7.3 The contestable retail control

7.3.1 What is it?

In the contestable market, we intend to regulate using **default tariffs and default service levels**. This would introduce a set of regulated prices and associated service levels for customers that all players would need to offer as the market opens up.

7.3.2 Why do it?

This would be a simpler regulatory approach compared with the one we use currently. It would give customers protection while the market develops without constraining the companies in developing the innovative new tariff and service offerings that those customers are asking for.

Where this type of choice has been offered to customers in Scotland, we have seen increased demand for water efficiency and water savings activities from business customers. When the retailer responds to this demand, it can bring real benefits to customers in terms of reduced bills. It can also bring real benefits to the environment because less water is wasted.

7.3.3 What stakeholders said

In general, companies (including entrants and incumbents) supported the introduction of a default tariff. But they raised particular concerns about:

- how the defaults would be set;
- whether they would include a margin; and
- whether they would continue to be indexed at RPI.

Respondents also queried how we move from existing tariffs to the defaults, and what the default standards of service should be.

Other stakeholders were similarly supportive of a default or safeguard price cap approach. They emphasised the importance of getting the level of default tariffs right to both encourage entry and protect consumers.

7.3.4 Next steps

We agree with the concerns that the companies and other respondents raised. We intend to consider some of these in our forthcoming consultation on retail issues. We will also carry out further work with the companies and other stakeholders over the summer. We have set out how we intend to do this work in our next steps document.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.

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