CLIFFORD CHANCE

Briefing note

November 2012

Price control in the water industry: do you trust me?

On 26 October 2012 water regulator Ofwat published revised proposals to modify the licence conditions of water companies. These proposals will give Ofwat a much greater degree of discretion in the price control mechanism and could also impact current and prospective investors in this sector.

All change in the water sector?

Ofwat has published proposals to reform the way in which it sets the prices that regulated water and water and sewerage companies can charge customers in England and Wales. If adopted, these proposals would allow a much greater degree of flexibility over the activities in scope to price control, the way in which prices are controlled and the duration of the price control period. Moody's issued a statement following publication of the Ofwat proposals indicating that it thought that both the current uncertainty over the price control mechanism and the future impact that Ofwat's proposals might have were credit negative.

Under the current regime, Ofwat conducts a five yearly price review which determines (for each company) a single overall price limit. The price limit allows a return on investors' capital calculated by reference to the company's regulatory capital value (RCV). The price limit is known as the 'k factor' and is expressed in terms of an increase (or decrease) in prices from the previous year, indexed for RPI. Since the last price review process in 2009, Ofwat has been considering ways in which it might modify the price control mechanic, in particular, so as to introduce separate price controls for wholesale and retail activities. The first set of proposals in December 2011 was rejected by all water companies.

The current proposals retain the notion of a 'k factor' and the link with RPI in respect of future price limits applicable to wholesale activities, but provide no insight into how Ofwat might regulate retail activities. Moreover, they allow Ofwat considerable discretion to move activities from the wholesale price control regime into an activity specific price control regime or indeed out of any form of price control – subject only to a limit of 20% of turnover (calculated on a sector-wide basis) that can be re-designated within any one price control period and 40% across two or more price control periods.

Each water company has until 23 November 2012 to accept these proposals (in which case their licence would be amended accordingly) or reject them, in which case Ofwat has indicated it would refer the matter to the Competition Commission (CC) for it to decide whether Ofwat's proposals should be adopted.

It is quite possible that a number of water companies will reject Ofwat's proposals, triggering a CC review process likely to stretch into late spring 2013. Subject to the outcome of a CC reference, the proposals controls are expected to come into force on 1 April 2015.

Key issues

- Ofwat is proposing increased flexibility to allow separate price control regimes for wholesale and retail activites and to vary the duration of controls
- RPI based return on RCV to be retained for the wholesale control: status of retail price control uncertain
- Ofwat proposals would allow up to 40% of revenues to migrate from wholesale to retail price control
- Water companies have until 23 November to accept the proposals or face a lengthy CC review process

The key differences

Issue	Current regime	Proposed regime
Number of price controls	Single overall price limit based on a tariff basket approach	Multiple price controls covering wholesale and retail activities separately. Each activity could have separate controls (e.g., one for water and one for sewerage).
Role of regulatory capital value (RCV)	Price limits include an allowed return on RCV	Return based on RCV to be retained for wholesale activities, but different form of price control possible for retail activities.
Link to RPI	Price limits are indexed to RPI based on the RPI +/- K formula	Wholesale price limits indexed to RPI "for the foreseeable future"; retail price limits uncertain.
Duration of price control period	5 years	The first "new" price control period (from 2015) will be 5 years for both wholesale and retail activities, but this may change in subsequent price review periods.
Changes to activities in scope to price control	Not possible without licence amendment	Activities representing up to 20% of turnover may be "re-designated" (from wholesale to retail or vice versa) within a given price control period, and up to 40% over two or more periods.

Evolution or revolution?

These developments are driven by Ofwat's concern that the current price control regime is too inflexible to enable the industry to adapt to the challenges of issues such as climate change, population growth and customer expectations and to support the reforms being proposed in the draft Water Bill such as increased competition in non-household water supply and more flexible wholesale pricing.

Ofwat has been at pains to highlight the limits of its proposals and the continuing safeguards that exist within the regulatory framework. These safeguards include Ofwat's duty to ensure that water companies can finance the proper carrying out of their functions and the continued role of the CC to consider appeals to price control determinations. Ofwat has also highlighted areas of continuity and an intention to introduce change incrementally. For example, initially, the price control review period will remain at 5 years with 100% of RCV being allocated to wholesale activities and all efficiently incurred investment in the RCV at 31 March 2015 being 'protected'.

However, a number of key uncertainties will remain, including:

- which activities will be covered by price controls?
- which activities will be removed from the wholesale control and which activities will be included in retail controls?
- will retail prices continue to be indexed to RPI?
- over what time period will the price control operate?
- what will happen to RCV?

Evolution....	.... or revolution
Ofwat has a duty to ensure that water companies can finance the proper carrying out of their functions	Ofwat has previously expressed the view (endorsed by the CC) that this duty means only that Ofwat must ensure an efficient water company should have access to finance on reasonable terms. This means that water companies (and their investors) adopt their chosen capital structure at their own risk and any assumptions as to revenue flows underpinning a particular choice of capital structure will not be protected by Ofwat, nor will price limits be set in order to ensure that a company's investment grade credit rating is maintained without first considering whether additional investment by the company's shareholders would be a more appropriate way of maintaining investment grade rating.
According to Ofwat, at least 90% of a water company's assets would remain as part of the wholesale function under any scenario currently in contemplation	Activities representing as much as 40% of the turnover of the business may be moved out of the wholesale price control and made subject either to a form of retail price control or subject to no price control at all. It is not clear how the 90% (asset) figure remaining part of the wholesale function can be reconciled to the 40% (revenue) figure that can be migrated to the retail function and what impact this will have on RCV and the level of allowed return on RCV.
Water companies will still have the option of rejecting a given price control settlement, so triggering a review by the CC	Once a more flexible price control framework is introduced into the licence, future reviews by the CC in the context of specific price controls will have limited scope to consider whether the discretion afforded to Ofwat is appropriate.
Ofwat's proposals bring the water sector into line with other price controlled industries, such as energy	Other sectors do have more flexible price control regimes, allowing regulators to better target incentives and enabling a greater degree of sharing of risk and reward. However, the potential implications of Ofwat's proposals are greater than in other sectors including because water companies are vertically integrated and most other regulated sectors have been unbundled. This means that the potential for a differentiated approach to price regulation is much greater in the water sector.

Conclusion

A number of water companies are reported to be considering rejecting Ofwat's proposals and so a CC inquiry into this issue looks likely. The CC will need to balance a number of competing objectives – in particular the trade off between regulatory certainty (and the positive investment climate this creates) and the flexibility needed to tackle the future needs of the industry. Some degree of change appears likely, but whether Ofwat will secure the level of discretion it is currently seeking remains to be seen.

Authors

Jenine Hulsmann
Partner

T: +44 20 7006 8216
E: jenine.hulsmann
@cliffordchance.com

Richard Blewett
Senior Associate

T: +44 20 7006 8211
E: richard.blewett
@cliffordchance.com