Ofwat’s regulatory reforms
For whom?
Adrian Kennedy
Head of Regulation
What are we going to cover today?

• Revenue and prices
• Ofwat’s reforms
  • Consequences
  • Supply Chain
• Closing thoughts
Building blocks: Current

Outputs

- Maintain current/Base levels of service
- New Quality obligations
- Enhanced Levels of Service
- Maintain the Supply/Demand balance

Expenditure requirements

- Operating expenditure
- Capital maintenance (Depreciation)
- Return on capital (RCV x WACC)
- Tax
- Incentives

Revenue requirement

Price limits ‘K’ revenue

Base revenue i.e. revenue streams with zero K
Building blocks: Proposed

**Outputs**
- Maintain current/Base levels of service
- New **Quality** obligations
- Enhanced **Levels of Service**
- Maintain the **Supply/Demand** balance

**Expenditure requirements**
- Fast Money (PAYG)
- Capital maintenance (Depreciation)
- Return on capital (RCV Slow money x WACC)
- Tax
- Incentives

**Revenue requirement**

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**Wholesale control**
- Contestable
- Non-Contestable

**Retail control**
- Water
- Wastewater
Outcomes
Costs and totex
Water supply and abstraction
Financing
Price controls
Outcomes and delivery incentives

Consequences
- Identify what customers need
- Identify right balance of activity
- Manage the cost
- Over deliver for customers

Supply Chain
- Operate assets reliably
- Optimise performance
- Manage problems at source
- Solution orientation

<table>
<thead>
<tr>
<th>Outcomes and Delivery incentives</th>
<th>Wholesale Water service</th>
<th>Wholesale Sewerage service</th>
<th>Retail service – household</th>
<th>Retail service – Non-household</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company to determine outcomes and incentives, minimum standard likely for leakage and AIM</td>
<td>Company to determine outcomes and incentives</td>
<td>Company to determine outcomes and incentives, minimum standard likely for SIM</td>
<td>n/a</td>
<td></td>
</tr>
</tbody>
</table>
- Totex (capitalisation percentages)
### Cost assessment, cost recovery, cost incentive

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<tr>
<th>Cost assessment, recovery and incentive</th>
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<tr>
<td>Totex using full service models for baseline assessment</td>
<td>Totex, baseline assessment with better models for networks and more traditional approach for non-infrastructure</td>
<td>Average Cost To Serve (ACTS) methodology, with glide path for inefficient companies</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Totex menu for water service</td>
<td>Totex menu for sewerage service</td>
<td>n/a</td>
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</tbody>
</table>

### Consequences

- Invest and operate at lowest whole life cost
- Make the best decision for the given situation

### Supply Chain

- Innovation in service delivery
- Understand asset life
- Understand reliability
- Understand costs
Water supply incentives

<table>
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<th>Water Supply Incentives</th>
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<th>Retail service – Non-household</th>
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<tr>
<td>Water trading and Abstraction Incentive Mechanism</td>
<td>n/a</td>
<td>n/a</td>
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<td>n/a</td>
</tr>
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</table>

Consequences

- Think of water as an asset
- Utilise opportunities for trading wholesome water
- Avoid unnecessary capital investment

Supply Chain

- Network modelling
- Resource optimisation
Financing

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<th>Financing and risk</th>
<th>Wholesale Water service</th>
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<td>WACC x RCV (water service)</td>
<td>WACC x RCV (sewerage service)</td>
<td>Net margin on costs</td>
<td>Gross margin per customer</td>
<td></td>
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<tr>
<td>Flexibility in timing of revenue</td>
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<td></td>
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<tr>
<td>recovery</td>
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Consequences

• Wholesale provider focussed on long term provision and operation of assets
• Retail provider focussed on service delivery and revenue recovery

Supply Chain

• Efficient asset procurement and operation in wholesale
• Customer led service provision
• Value added retail services
## The ‘Price Controls’

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<th>Binding ‘Price Control’</th>
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<td></td>
<td>RPI±X approach with a blend of a total revenue control and a revenue yield approach, incorporating an annual adjustment to allow for differences in demand and metering</td>
<td>RPI±X approach with a simple total revenue control</td>
<td>Retail revenue price control (no RPI indexation)</td>
<td>Default tariffs based on the company’s existing tariff structures (no RPI indexation)</td>
</tr>
</tbody>
</table>

### Consequences

- Annual revenue correction providing improved protection for metering and demand change
- Retail prices subject to competitive pressure

### Supply Chain

- Drive efficiency without regulatory and statutory intervention
- Customer led service provision
- Value added retail services
- Manage input prices in retail services
For whom?

- Meet customer needs
- Deliver in the most efficient way
- Focus on the solution not the asset
- Optimise the assets we already have
Ofwat’s regulatory reforms
For the customer
Adrian Kennedy
Head of Regulation