

Assessing the impact of change

It is around 6 months since we released Edition 1 of our Roadmap to Reform, and a lot of water has (intermittently) passed under the bridge since, not least during the so-called “wettest drought on record”.

Most importantly, Government has published a draft Water Bill for pre-legislative scrutiny, thus putting flesh on the bones of many of the proposals and commitments made in the Water White Paper. The reforms will drive significant change to the market as a whole, including the way companies operate their businesses and IT systems across the value chain, and how they can deliver best value to shareholders. The proposed reforms include:

- Extending the retail market to all non-domestic water and sewerage customers in England and steps towards a cross-border market with Scotland, to be implemented by April 2017;
- Encouraging unbundling and entry upstream by creating a number of new licences for specific activities. Government has been more aggressive than expected in this area, while at the same time retaining vertically integrated licences for incumbents;
- Provision for market codes setting out obligations and rules for market participants, and reforms to the way undertakers may charge for water and

sewerage across the value chain, including replacement of the Costs Principle. Ofwat will be largely responsible for driving implementation; and

- Reforms to the special merger regime, which are expected to enable increased M&A activity.

In addition, there has been substantial progress on the development of the methodology for PR14, with the release of a number of consultation papers and stakeholder workshops, all leading up to the Draft Methodology Statement due later this year. Ofwat's reforms to regulation and price controls are designed to enable the market reforms set out in the Draft Water Bill, and to drive future performance. These include:

- Separate retail and wholesale price controls; along with accompanying licence reforms and reporting changes to enable separate controls. These changes will impact on companies' approach to compliance, reporting and the operational directions for their businesses. In particular there is a strong encouragement towards increased water trading between companies;
- Changes to the incentive regime, and to the requirements for engaging consumers. These will affect how companies make their case to customers and regulators, and

how they are remunerated within the price control settlement, and hence will be at the centre of companies' delivery strategy, particularly if a totex approach is also implemented as part of the package.





There have also been other important events, including:

- the successful acquisitions of several WOCs – Cambridge Water and Veolia Water;
- release by the companies of the first Risk & Compliance Statements and stripped-down Annual Returns;
- initial steps into competitive retail markets by several companies, including Severn Trent and Thames Water.

While the establishment by Government of a multi-stakeholder High Level Group to take forward retail and upstream reforms is to be welcomed, uncertainty in timing of policy decisions, the lack of a detailed implementation roadmap, and the resulting difficulty in assessing the impact on business plans is likely to remain a fact of life for a while yet. The devil will be in the detail, and the degree of new entry will potentially be determined by access pricing and the terms of the various codes contemplated by the Bill. Companies need to respond proactively to the market changes in order to influence policy implementation and to prepare their organisations for the challenges of the evolving market.




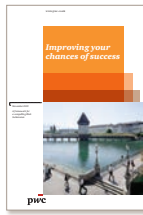
Contacts

PwC has an experienced water sector advisory team delivering strategy and implementation advice across the sector. If you would like to discuss the contents of our “Roadmap to reform in the UK water sector” and how they impact your business, or would like to receive a hard copy, please contact one of our water sector specialists:

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Our insights

We have published a selection of thought pieces on the ongoing reforms in the water sector, and a sister “Roadmap to Reform” in the UK power sector. Please contact any one of our team for a copy:

	Watergroup Bulletin Our bulletin summarises recent news and our thinking about changes in the water sector.		Water White Paper We summarise the headline content of the Water White Paper and identify arising key issues for businesses.
	Future Price Limits We discuss the implications of Ofwat's Future Price Limits project, and its impact on the next price review.		Improving your chances of success We discuss how to prepare a compelling IDoK submission to Ofwat.

What we can do for you

The industry changes proposed in the Water White Paper and Ofwat's price review are substantial. Our people are able to draw on their wealth of experience in the water industry and other regulated sectors to support your business in the face of reform.

We can help you:

- Develop your business strategy and optimise your operations to pre-empt and capitalise on the incoming market reforms - upstream and downstream.
- Prepare for PR14, including developing your well justified business plan submission to Ofwat.
- Deliver AMP5/PRO9 targets, including capital and operational efficiency plans and compelling IDoK submissions.

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Implications of the key facets of water reform

We have considered the key areas of reform and outlined our view of the progress that has been made to date alongside the activities we might expect companies to begin to undertake.

Price control reforms

Progress made

- Ofwat has published its broad approach to future price limits, has consulted on retail definition for PR14 and on wholesale incentives
- Meanwhile, companies are preparing their business plans in the key areas identified in previous controls, anticipating the main policy changes, as well as provision for the new sewerage assets the WaSCs now control
- Enabling licence modifications for separate retail and wholesale price controls have been delayed to Q4 2012
- Ofwat's methodology paper is due for publication in Q4 2012

Potential impact on water companies

- Potential need for significant re-work of business plans if Ofwat's methodology does not contain the anticipated changes (e.g. on retail definition and overall incentives package, including totex)
- One business plan only at PR14 means that companies have one less chance to get their case across to Ofwat
- The methodology may not deliver clarity over the detailed approach Ofwat will take, leading to continuing uncertainties for companies

Retail market reforms

Progress made

- Retail market expected to open to all non domestic water and sewerage consumers in England from April 2017. Industry working groups are being set up to deliver the reforms
- Companies will be involved, as part of wider industry working groups, in the development of a framework and market codes for a competitive water market
- Ofwat to develop the licensing framework for retail entrants, including mutual licence recognition with Scotland
- Companies wanting to participate in the competitive market must set up a legally separate limited company and apply for a licence. This is, however, not the case for a new entrant that is not associated with an incumbent water company

Potential impact on water companies

- The policy debate on retail is over, and is now largely an implementation challenge – stakeholders will need to work together and with Ofwat/DEFRA to deliver the required market design, systems and processes in advance of market opening
- Increased competition will put pressure on incumbents to improve their product and service offering for both water and sewerage. Entrants will also have flexibility to expand their offering. Some companies are already beginning to set their stall out and make early strategic moves
- Ultimately, Companies will need to prepare for increased switching and have systems and processes to deal with this

Upstream market reforms

Progress made

- The draft Water Bill makes proposals for upstream market opening and unbundled licences
- Ofwat initiatives to help facilitate water trades through the introduction of regulatory incentives to make trading more attractive
- The High Level Group has a remit to progress upstream reform in parallel with retail, however implementation timelines unclear as yet

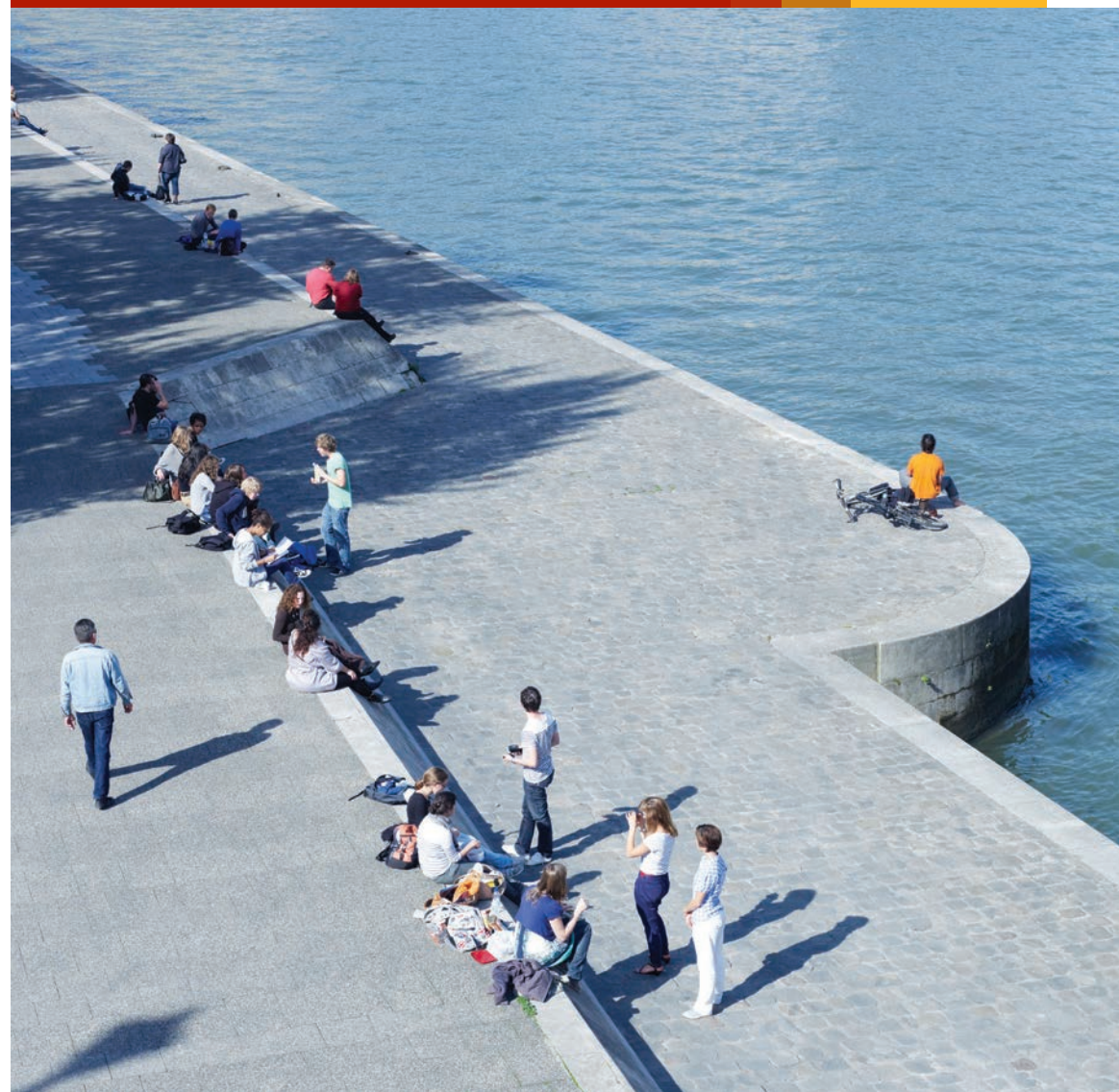
Potential impact on water companies

- The introduction of water trading will be positive for consumers, but will have varying impacts on water companies in terms of water resource management opportunities, risk management and internal capabilities
- Upstream, there is a substantial policy debate still to be had on the extent and forms of reform, the potential impacts on incumbents' assets and businesses, and the benefits for consumers. Stakeholders are not aligned on the appropriate ways forward. The design of upstream market arrangements is likely to be complex, and significant work from government, regulators and the industry working groups will be needed to implement them, with uncertain outcomes

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Roadmap to reform of the water sector

Issue 2: October, 2012



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Indicative Timetable

		2012			2013				2014		2015		2016		2017 onwards	
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	H1	H2	H1	H2	H1	H2		
Policy	Water Legislation Proposals set out in the Water White Paper are to be enacted in England through changes in primary legislation. The market reform aspects of the water white paper are expected to be enacted through the water act.		Defra published Draft Water Bill prelegislative scrutiny by Efra committee	Welsh Assembly to prepare Water Policy Statement and develop a water strategy for Wales		Water Bill to enter Parliament (?) Welsh government to start operating new organisation for the protection of natural resources			Water Bill enacted. (?)							
	Licence Reform Ofwat has proposed to change the water licensing framework to simplify it and have greater flexibility in setting price limits; Defra has proposed unbundling new entrant licences, and extending licencing authorisations to sewerage.		Ofwat consult on proposed licence changes	Ofwat to implement ELM changes	Companies may refer ELM to Competition Commission (?)				Unbundled retail licences developed		Ofwat to have licence application process in place	Development of other unbundled licences (?)	First unbundled licences awarded (?) Transition existing WSL licence into the new licensing regime			Retail infrastructure licences come onstream replacing existing Inset appointment regime (?)
	Regulatory reporting Ofwat has proposed to simplify regulatory compliance. June Returns will be replaced by simplified Annual Returns. Regulatory accounting guidelines are to be introduced.	Companies submitted first Annual Returns Ofwat consulted on revised regulatory accounting	Ofwat publish regulatory accounting guidance (RAG) and auditor's guidance Companies publish performance indicators, risk and compliance strategy and regulatory accounts		Revised regulatory accounts come into force	Companies to submit Annual Returns in accordance with revised RAG and accounting separation by services			Companies to submit Annual Returns	Review of implementation of IFRS for regulatory accounts	Companies to submit Annual Returns	IFRS for regulatory accounts becomes effective	Companies to submit Annual Returns		Companies to submit Annual Returns	
Pricing	Price review Ofwat's future price limits (FPL) workstream is revising price setting practices in water and sewerage to improve efficiency, enable market reform through separate price controls for retail and wholesale, and focus on 'outcomes'. Many of the FPL reforms will be applied in the 2014 price review		Companies to start developing business plans focussed on long term outcomes Ofwat to run workshops/working groups in preparation for the methodology consultation	Ofwat to consult on proposed methodology for the next price control review	Ofwat publishes final methodology for next price control	Companies reflect final price control methodology in business plans			Companies to submit business plans Ofwat to prepare draft determination Companies prepare representations in response to Ofwat draft determinations	Ofwat to publish final determinations Companies to undertake feasibility and design studies to enable early commencement of capital programme delivery	New price controls take effect in April 2015 Companies decide whether to refer to CC for final determination	CC appeals (if any) concludes	CC final determinations come into force			Ofwat to consult on length of price controls for the 2019 price control
	Charging framework Ofwat has proposed to revise water charging framework to better reflect water usage and facilitate market reform	Ofwat published charging discussion paper	Companies to publish revised charges principles and guidance			Companies develop potential wholesale charging and default tariff schemes			Companies to incorporate revised wholesale charges and default tariffs in business plans Ofwat to consult on possible framework for charging, CAP to report to Ofwat		Retail and wholesale price limits including default tariffs come into force				Wholesale charges and default tariffs come into effect for the revised contestable market	
	Customer engagement Customer engagement will be a key input to the 2014 price review. Companies will need to consult with consumers through the CCG.	Companies convened customer engagement groups	Ofwat to consult Customer Advisory Panel (CAP) on price setting process		Optional publication of strategic direction statement (?)			Companies to consult with customer enagement groups ahead of final business plans								
	Social tariffs Government has planned for additional measures to help disadvantaged customers pay their bills: social tariffs for financially stressed households.	Defra published social tariff guidance				Companies to introduce enhanced tariffs from April onwards										
	Consumer protection Ofwat is to review policy on consumer protection. The future of Consumer Council for Water will be reviewed again	Ofwat published consumer protection policy statement	Ofwat to consult on any proposed changes to consumer protection tools	Ofwat to respond to Defra consultation on company social tariffs					Review of Consumer Council for Water	Codes of practice on mis-selling developed by Ofwat					Code of practice on mis-selling comes into force (?)	
Markets	Private sewers Private sewers and lateral drains connected to the public sewerage system were transferred on 1st October 2011. The Government intends to work closely with Companies to address technical issues associated with the transfer along with future transfer of pumping stations.	Companies develop asset strategy for private sewers transferred in October 2011		Companies consider preparing for IDoK				Companies consider preparing for IDoK		Companies prepare planned maintenance schedules for new assets				Date by which private sewer pumping stations will be transferred to companies	Companies develop asset strategy for private sewer pumping stations transferred	
	Retail market expansion The draft water bill enables the initial proposals in the WWP to extend water and sewerage retail competition to all non-household customers, to unbundle upstream and retail licences, and to link the English and Scottish markets, increasing the size of the contestable market to 1.4 million customers		Companies to respond to Ofwat's consultation on retail controls Defra to establish steering groups	Establishment of industry working groups	Design of framework for licence recognition in England and Scotland Ofwat to develop new retail market governance framework	Develop preferred market design for England and harmonisation with Scotland				Companies to procure preferred systems to prepare for market opening (?) Ofwat to support companies in procurement of preferred systems (?)				Companies make final preparations for B2B retail market opening	Market operator established (?)	Retail market opening in/after April 2017
	Upstream market expansion The Draft Water Bill contain proposals to increase upstream water competition, and Ofwat is expected to consult on best ways to achieve this.			Working groups develop model bulk supply contracts (?)		Companies to review sludge costs and access to facilities			Companies develop wholesale market codes and contracts Ofwat to develop principles and governance for wholesale market codes and contracts (?) Ofwat to develop principles for contracts and governance		Companies develop the wholesale charging scheme (?) Ofwat to develop principles and governance for the wholesale charging scheme (?)	Ofwat to perform market systems testing				Companies to prepare for upstream competition (?)
	Water trading As part of the management of water resources and security of supply, Ofwat consider water trading an important element. This involves determining a value for water and managing it effectively		Ofwat consult on water trading framework				Ofwat to conduct workshops to implement market reforms for water trading incentives (bulk supply trading between incumbent companies)		Defra to consult on new abstraction regime Defra to publish proposals to reform water abstraction licencing system Companies to plan and hedge for short and long term changes in abstraction					(2016+) Implementation of new abstraction proposals		
	Abstraction reform Defra has proposed to reform the abstraction regime, to account for changing demographic and environmental pressures - reducing overabstraction, and facilitating abstraction trading	Design of new abstraction regime (?) EA published information on abstraction licence trade prices, volumes and locations	Defra to consult on new abstraction charging (?) EA gains ability to revoke licences without compensation													
Environment / Resources	Mergers and acquisitions The water bill provides for a reformed special merger regime with remedies offered by companies as an alternative to CC referral	Defra consulted on turnover threshold for merger regime.		Decision on threshold for merger regime (?)		Decision included in the water bill (?)	Provision in draft water bill for companies to offer remedies to reduce detriment caused by the merger			Ofwat to publish methods for valuing loss of a comparator (?) New merger regime comes into force (?)						
	Environmental quality programme The Environment Agency (EA) is the managing body for the environmental quality programme that companies will deliver through their business plans and price determinations	Defra to consult on national strategy for urban diffuse pollution	Ofwat to publish policy statements on climate change, water resources, and water quality	EA to set objectives and measures for each river basin district for RBMP1 Defra to prepare strategic policy statement for Ofwat	Defra to publish revised social and environmental guidance Defra to set dates for RBMP to: 2010-2015, 2015-2021, 2021-2027		EA to review natural and economic characteristics of each river basin district	Companies to start drafting RBMP 2	EA to review RBMP1	Defra to review progress to date on RBMP 1 and plan for future RBMPs	Companies to finalise RBMP 2					Key: Defra/ Government Ofwat Companies Environment Agency Dependent on the Water Bill
	Water resource management plans The WWP contains proposals to realign water resource management plans (WRMP) to increase coordination between the management of water resources	EA to develop guidance on water resources planning Ofwat consulted on how to best incentivise water efficiency		Companies to consult on draft WRMP	Defra to set dates for WRMP to: 2013-38, 2018-43, 2023-48 Companies to publish draft WRMP	Public consultation of draft WRMP	Companies to produce 'statement of response'	Final WRMP checked by EA Water companies to take account of water trading reforms in their water resources management plans Water companies may 'bid in' resources to others' WRMPs Companies to include metering plans in business plans and WRMP	Companies submit final WRMP to Ofwat Companies publish final WRMP							
	Drought planning In the draft water bill, Defra has proposed in the to realign drought plans to follow at 5 year cycle	Possible hearing on draft drought plans	Companies to publish final drought plans		Defra to set drought plans to follow 5 year cycles			Secretary of State directs companies to amend plans if necessary				Companies to submit drought plans for approval				