Ofwat's Future Strategy for Customer Charges for Water and Sewerage Services: A Consultation

CCWater response

April 2008

Consumer Council for Water

Introduction

1. The Consumer Council for Water (CCWater) represents the interests of water and sewerage customers across England and Wales. We have four regional committees in England and a committee for Wales. This response reflects our collective view.

2. We welcome the opportunity provided by the consultation to influence Ofwat's future strategy with respect to water and sewerage charges.

Executive Summary

3. This response follows the format of the consultation paper and provides our views on the specific questions raised. The key points which we would wish to highlight are as follows:

    - We can currently see no compelling case to move to an alternative form of unmeasured charging, given that to do so would create significant incidence effects and would not represent progress in terms of achieving greater fairness in water charging.
    - We agrees that metering is the fairest way to pay, but we have significant concerns about the scale and pace of its implementation;
    - The additional costs and regressive incidence effects associated with metering mean that the issue of affordability for low income households must be addressed before progress towards more widespread metering can occur;
    - It is the role of Government, not water companies or Ofwat, to address this social issue using the tax and benefit systems;
    - The pace of meter installation should also reflect regional water resource circumstances. Metering should be considered alongside other supply/demand options and subject to the same cost benefit and cost effectiveness analysis;
    - We support the principles of cost reflective charging and agree that companies tariff structures should reflect their individual circumstance;
    - We welcome the examination of alternative tariff structures which seek to address specific issues such as resources management;
    - CCWater questions whether the introduction of tariffs aimed solely at enhancing customer choice is appropriate in the context of the delivery of an essential service. We are concerned that the introduction of such tariffs might only serve to increase customer confusion and that they may favour well informed, proactive customers over those who may be less confident or equipped to make choices about their charges;
    - We strongly support Ofwat's approach on both site area based charging and Assessed Charges and would be happy to work with them in progressing these issues.

Updated Charging Principles and Supporting Strategies

4. Since this consultation was launched, Defra has announced a major independent review of charging and affordability issues. Many of the issues raised in this consultation deserve examination without preconceptions in that review. While the charging principles outlined in Chapter 2 of the consultation document are generally sound, some principles are potentially in conflict with others. There is also a serious shortage of empirical data on some topics. An evidence gathering review could be useful in exploring these in more detail. We raise in this response some issues that would benefit from detailed analysis before policy is settled.

5. There are likely to be circumstances where, in reaching a decision on certain issues, Ofwat will need to give greater weight to one or more of these principles than to others. This may, for example, be necessary when attempting to balance the requirement for charges to be equitable and cost reflective whilst also ensuring that they are affordable to all customers, including those who are vulnerable.

6. In reaching decisions on issues where there is potential conflict we would wish to see Ofwat clearly demonstrate that it has taken account of consumer views and the potential impact on those affected.

Policies

Unmetered Charges

7. We share the view that there is no compelling case to move to an alternative form of unmeasured charging, given that to do so would create significant incidence effects and would not represent progress in terms of achieving greater fairness in water charging.

8. We recognise that as more high RV customers opt to be metered current cross subsidies which operate in favour of low income unmeasured households will gradually diminish, and that this process may be accelerated under a programme that delivered higher levels of metering earlier. Ultimately failure to address this issue could lead to the continued use of RV charging becoming unsustainable

9. It is important to assess the distributional impact of a progressive reduction in RV related cross subsidies as metering expands. Although the UKWIR study of tariffs and affordability has not yet been finalised, we understand that optant metering has been chosen more often by people in higher RV property, with higher incomes, and by smaller households. There is little evidence on the consequences of compulsion for low RV, low income families – especially larger households. In the interdepartmental review of water affordability in 2004, it appeared that the scale of RV cross subsidies and the effect of unwinding them was a significant factor limiting the case for compulsory metering. The extent of this effect needs to be reassessed in the context of the new policy on metering in areas of water scarcity. It may be that higher RV households tend to use more water than low RV

households, and that their contribution to revenues will continue to be towards the higher end of the scale in any predominantly volumetric system of charging. But the evidence base for this assumption needs to be reviewed. The scale, consequences and phasing of winding down the RV system has yet to be given the attention it deserves.

10. We believe that it is the role of Government, rather than water companies or Ofwat, to address any breach in social protection which arises from this. They should do so by providing appropriate assistance through the tax and benefit systems. The House of Lords Select Committee Report on UK economic regulators (November 2007) advised that, *"Government should be careful not to offload political policy issues onto unelected regulators".* The Government responded to this in February 2008 by saying, *"The Government agrees that political policy issues should not be delegated to the regulators. It is important that the clear dividing line between government and regulators should be maintained. It is helpful for regulators to be given guidance by government on issues that are matters of public policy."*

11. We agree that RV modifiers should not be increased without the introduction of appropriate protection for low income customers. We believe that such assistance would need to be provided by Government in order to avoid simply swapping one cross subsidy for another.

Metering

12. Metering is recognised by most consumers as the fairest way to pay.[(1)(2)] Although willingness to support and recognise the fairness of metering will also be dependent on the impact on their bills in practice. If customers economise they will expect bills to reduce. If bills rise steeply as consumption falls (which is possible for a significant proportion of households if environmental mitigation costs rise steeply in the next two AMP periods) their sense of fairness will be tested. We agree that a higher level of metering is an appropriate long term goal, but the Consumer Council see the pace of change in relation to other cost impacts, together with a solution to affordability problems, as critical to public acceptance.

13. We agree that metering can have several beneficial impacts. This is especially the case where households have access to information on their usage and good advice and access to more efficient water using appliances. The evidence base on water savings and elasticity effects is, however, rather general, and a combination of trials and modelling of likely impacts is important to refresh it. For example a general reduction in water usage of about 10-15% following installation of a meter is often referred to. But optants for meters had often started to reduce their consumption well before a meter was installed, and a read across to compulsorily installed meters cannot be taken for granted. Elasticity effects also need to be understood before innovative metered tariffs are rolled out on a wide scale. One possibility is that elasticity of demand will be a function of income as well as price. It would be a waste of resources and a policy failure to set up extensive compulsory metering if this has only a modest

effect on higher earnings consumption, but creates a strong pressure to reduce consumption in lower earning households.

14. In summary, we agree that metering is the fairest way to pay, but we have significant concerns about scale and pace of its implementation. These relate to:

    - The costs of a large scale metering programme which will impact customers' bills.
    - The risks of combining a drive towards metering with rises in bills driven by ambitious environmental mitigation investment;
    - The regressive 'incidence effects' on some customers' bills, particularly customers on low incomes with large families living in homes with low rateable values, who will pay much more when metered unless tax and benefit changes or innovative tariffs offset the changes.
    - Consumers' distrust of water companies and the concerns many bill payers will have if a meter is imposed on them rather than chosen by them.
    - The limited evidence base on elasticity and changes in demand – which suggests that successful tariff trials and a thorough review of impacts should be a precondition of implementation of compulsory programmes;
    - The uncertainty over the effect on water companies' income streams should metering produce a significant reduction in demand, which would lead to an increase in the unit price of water and potentially increase the mistrust and suspicions consumers report.

15. We believe that the issue of affordability must be addressed before there can be any significant acceleration of metering. This is a social policy issue that should be recognised and addressed by Government using the tax and benefit systems.

16. The implementation of metering, and the costs associated with it, need to be spread out over a period of time sufficient to smooth the impact on bills and allows customers time to adjust to the idea of metered charging.

17. The pace of meter installation should reflect regional water resource circumstances. Metering should be considered alongside other supply/demand options and subject to the same cost benefit and cost effectiveness analysis. We accept that Government has set an ambitious programme in areas of water scarcity. But even here the comparative cost effectiveness of metering compared to other means of addressing the water resource balance will be a relevant consideration.

18. We believe the following factors need to be considered in gaining a better understanding of the costs and benefits of accelerating the uptake of metering and in determining at what point universal metering becomes appropriate.

As a demand management tool

- All stakeholders agree that a shared goal is the sustainable management of water resources;
- Meters, are likely to make customers more aware of their water use, help identify supply pipe leaks (where fitted externally) and could curb excessive use at peak demand times;
- Although there may be an initial reduction in household demand following installation of a meter there is scope for better evidence that this is sustainable n the longer term;
- Increased metering could bring the possibility of introducing rising block or seasonal tariffs which provide financial incentives to use water wisely. These raise urgent questions of design and practicality: a rising block tariff that makes no allowance for household size is likely to penalise large households, while offering hardly any incentive to restraint for single person households. Yet the administrative complexity of making allowances for household size are regarded as formidable by some water companies, and raise privacy and verification issues;
- Elasticity effects are little understood. Does demand reduce simply from the fact of having a meter, or is it a function of the price signals of the tariff or the income of the household? European experience suggests that extensive metering is not alone sufficient to guarantee government targets of 130-120m^3 per capita consumption (PCC). Many countries (especially in the relatively low rainfall and relatively affluent parts of Europe) have metering and PCC of 150m^3 or much higher;
- Education and information campaigns are essential in order to change consumer attitudes and behaviours in their water use;
- Successful demand management and promotion of water efficiency, coupled with metering may reduce average per capita consumption, but overall demand will also be driven by regional population growth and demographic changes including reducing household size;
- Population trends coupled with the prospects of climate change leading to much drier summers are likely to mean that investment in major new water resources is necessary and cost beneficial. Deferment of major resource development is unlikely to generate savings on such a scale that metering will lead to durable bill reductions for customers, and indeed bill reductions may be more than cancelled out if the environmental quality agenda leads to major new infrastructure costs;
- Large scale compulsory metering programmes benefit from economies of scale and the synergies achieved by linking them with other planned activities like mains relining and replacement;
- The current "scatter gun" approach to metering through optional metering and change of hands approach is less efficient. These costs are also borne by customers.

As a charging method:

- Metering would replace an obsolete charging system (RV), link bills to usage, move us towards a system where all customers were charged on the same basis;
- Metering has a high level of acceptability. Progress toward universal metering is generally supported by customers, with more enthusiasm by those already metered;

- Metering/paying in relation to what you use is viewed as the fairest charging method by the majority of consumers;
- Metering is a more expensive charging method due to the capital and operating costs associated with meter purchase (cost dependant on technology used), installation, maintenance, replacement, reading, billing and the resulting increased customer contact. They also impact on companies' revenue streams - RV accounts, in many cases paid in advance/metered retrospectively (these costs are passed on to customers);
- Large households with comparatively high water usage currently living in low rateable value properties are likely to see the biggest increase in their bills; if metering coincides with a high K outcome in PR09, there is a possibility of increases of the order of 200%;
- Having a meter typically benefits single/small households with below average use currently in higher rated properties;
- Metering may lead to initial bill reductions for some but these may be wiped out by subsequent price increases;
- Metering could allow those with higher discretionary use to offset future price rises by reducing their demand – it allows more control over bills;
- Paying by meter may result in those on low incomes compromising health/hygiene in order to reduce bills;
- Metering may exacerbate existing affordability/payment issues leading to increases in debt;
- Metering could facilitate the introduction of "social" tariffs, although research suggests that such tariffs do not have wide support from customers; [(1) (2)]
- If metering becomes more widespread it may lead to a greater take up of the WaterSure scheme. As the benefit is limited by movements in the average charge, this will strengthen the case for review of the assistance provided to vulnerable customers;
- Significant reductions in water requirements by society, will in turn reduce the revenue income for water companies. As Ofwat is charged to finance the functions of efficient water companies, customers are likely to see the price of water rise to meet the financial shortfall.

Metered Standing Charge

19. CCWater believes that metered tariffs should be structured to ensure that charges are fair to business customers and therefore cost reflective, rather than specifically to facilitate competition. We do, however, agree that by making charges cost reflective, it will be easier for new entrants to identify opportunities for efficient entry and thus for competition to develop.

20. In the interests of fairness and cost reflectivity, standing charges should continue to be used as a mechanism to recover fixed customer costs which do not vary with levels of water usage. There is also a case for Ofwat to address any inconsistencies which currently exist in terms of the composition and level of different companies' standing charges.

Cost Reflectivity

21. We support the principles of cost reflective charging and agree companies' tariff structures should reflect their individual circumstances.

22. It should be recognised however that cost reflective charging cannot be achieved in any systematic or ideal way, because the marginal cost to water companies of providing for additional consumption (especially in a wet year or unstressed area) will tend to be only a fraction of the enhanced charge at the upper end of the scale of a rising block tariff. For there to be a cost saving there needs to be a sufficiently reliable reduction in consumption to justify avoided investment in new water resources.

23. Companies' confidence in elasticity effects and whether reductions in consumption will be sustained are a matter of fine judgement. They are by law obliged to have water available for use to an extent which covers predicted consumption and leave a margin in a dry year. Yet changes in demography, population numbers and climate may in practice make it a risky business to plan with certainty. Many of their investment overheads and costs will not be variable in relation to marginal changes in consumption. It would be useful if Ofwat developed more analysis about which parts of company costs are likely to be responsive to volumetric changes, and which are not.

Seasonal Tariffs

24. CCWater research suggests that customers generally oppose the introduction of seasonal tariffs.[(1) (2)] There is a need to ensure that the case for the roll out of such tariffs in an area is adequately robust in terms of both cost reflectivity and projected water efficiency. Customers will need to be satisfied that seasonal tariffs represent the optimum solution to the water resource issues facing customers in that region.

25. We support Ofwat's view that water and sewerage costs should be addressed separately. The charges for sewerage services should not be adjusted under seasonal tariffs aimed at managing the demand for water. This will clearly have implications in terms of weakening price signals to consumers. However this can be taken into account in setting the level of the water charges. That is, the summer water tariffs will need to be set at a level which adequately reflects the long run marginal cost of peak usage

26. Confining structured tariffs aimed at delivering water resource objectives to water tariffs would prevent cross subsidies between water and sewerage customers. Specifically this would avoid discrimination between those customers who receive water and sewerage services from the same company and those who receive them from different companies, or rely on a septic tank for the disposal of wastewater.

27. This approach would also ensure that price signals are targeted at the right customers and not, for example, on customers who only receive a sewerage service from the company seeking to address water resource issues.

Rising Block Tariffs

28. We note Ofwat's observations with respect to Rising Block Tariffs. We agree that the construction of such tariffs should be undertaken with a clear understanding of purpose.

29. CCWater believes that to be truly fair and effective these tariffs will require companies to collect and maintain additional information about their customers. In particular they will need data on number of occupants living in each property. There is a need for these requirements and the associated costs to be taken into account by companies and Ofwat.

30. Where rising block tariffs are implemented with the aim of delivering water efficiency savings we believe it would be difficult, on cost reflective grounds, to justify sewerage tariffs following the same structure. Unless the benefits of merging the water and sewerage tariffs aspects can be clearly demonstrated we consider sewerage costs should be considered separately within the water charging structure reflecting the true costs of discretionary usage, and the high fixed costs of investment in sewerage infrastructure. Again an analysis of the ratio of fixed to volumetrically variable costs would be a useful contribution to the debate.

Tariff Trials

31. CCWater welcomes tariff trials which will test the impact of alternative measured tariffs on customer behaviour. The findings of such pilot schemes should be used to inform decisions about the future direction of charges, particularly in areas where a supply / demand imbalance has been identified.

32. To sharpen the focus and design of such trials, there is scope for prior modelling of possible impacts, and to consider the known effects of the application of alternative tariffs in other countries. It could be argued that it is impossible to design a satisfactory tariff structure without better information on elasticity, and the profile of existing consumption, especially the range of consumption at different household sizes around the mean average consumption. These factors are likely to be better understood if tariffs are developed and trialled in a wide variety of areas, and with a variety of different features.

33. We agree that trials operated on an optional basis are unlikely to provide valid data on 'real world' customer behaviour. However, we do have significant concerns about the imposition of alternative tariffs, which may in some cases significantly increase bills, when the necessary work has not yet been done to ensure customers at risk are protected. In particular, we are concerned about the impact which any resultant increase in charges or in the perceived marginal cost of water usage might have on low income and vulnerable customers.

34. It is essential that companies who are planning on implementing tariff trials work closely with Ofwat and CCWater in order to ensure that adequate mechanisms are in place to protect vulnerable customers from the potential impacts, either through exclusion or mitigation.

35. We believe that it is in the interests of the water industry to co-operate on this issue and to share the findings of early tariff trials. Enhancing the collective understanding of customer behaviour in response to alternative metered charging structures is, we believe, an adequate incentive for such openness.

Innovative Tariffs

36. In the context of a regulated monopoly, innovative tariffs are, we believe, most appropriate as a means of addressing specific issues, such as water conservation.

37. Tariffs which offer support or preferential treatment to certain groups, through either circumstance or a mechanism of self selection, should only be considered where this can be financed from consequential savings, for example, through a reduction in debt costs, rather than cross subsidy.

38. We consider that there is likely to be limited scope for the introduction of tariffs which offer genuine benefits to optants without transferring any cost burden to the existing customer base.

39. A proliferation of alternative tariff options would, in our view, increase confusion rather than serve customers' interests. There is a risk that customers' tariff choices might be driven by perception or company marketing rather than a rational evaluation of the facts. This situation is common place in other sectors but would be unacceptable in the context of a monopoly industry supplying basic essential services.

40. In considering the implementation of any optional tariffs it must also be recognised that their introduction is likely to favour the interests of informed, proactive consumers over and above those whose access to information is more restricted and who are likely to be less confident, and therefore willing, to make decisions about their charges for services.

41. We believe that it would be vital for Ofwat to retain responsibility for regulating the level of charges set under optional tariffs. Customers should not be excluded from such protection simply because they have exercised a choice in respect of their charges.

Affordability and Social Tariffs

42. We support the approach outlined in the consultation document and agree that it is the role of Government to address the policy issue and provide assistance to those at risk through the tax and benefit systems.

Assessed Charges

43. We agree that there is a need for some companies to offer assessed tariffs which more closely reflect individual household use. Specifically, we believe some companies do not currently offer an assessed tariff which provides an appropriate proxy for a metered bill to a single occupier household. This is of particular concern as it is this group which are most likely to seek the installation of a meter. We believe Ofwat should provide further guidance on this issue and would be happy to work with them in its development.

Sewerage Charges : Surface Water Drainage

44. We agree that site area based charging is the most appropriate mechanism for recovering the costs associated with surface water drainage, and strongly support Ofwat's proposal to require the companies who do not charge in this way to produce plans to phase it in.

Customer Choice

45. As highlighted in the above paragraphs on 'Innovative Tariffs' CCWater is concerned that a greater choice of tariffs may simply lead to increased customer confusion and the potential for a greater division between informed proactive consumers and those who are more vulnerable. This would, we believe, be unacceptable in the context of the supply of a service which is essential for life.

46. Without a robust evidence base to support its decisions, Ofwat should be very cautious of equating increased customer choice with consumer benefit.

Non-potable Charging

47. We agree that it is appropriate for charges to non-potable supply networks to be considered on a more locally cost reflective basis where there are significant differences in terms of the use of network infrastructure and therefore in the costs of serving the customer.

Technological Innovation

48. We support Ofwat's approach to this issue. We agree that the benefits of introducing technology such as smart metering should be weighed against the associated costs to customers and compared with other low tech solutions, such as more frequent and informative billing, which might deliver similar benefits at lower cost.

Impact Assessment

49. Although the impact assessment identifies the issues covered by the consultation it does not go far enough in identifying the potential impacts associated with those issues. In particular it would be useful for Ofwat to provide, for each area of policy, a more detailed and quantified analysis of which groups of customers are likely to be impacted, and to what extent.

50. The Consumer Council for Water would like to see Ofwat demonstrate clearly, its understanding of the consumers it is set up to protect, and recognise the different perspectives and priorities they can bring to impact assessments

References

(1) CCWater Deliberative research into consumer views on Fair Charging (Corr Willbourn Research - Feb 2007)
(2) CCWater Quantitative Charging Research (ORC – 2008 Not yet published)

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