

Protecting consumers, promoting value and safeguarding the future

Ofwat's future strategy for customer charges for water and sewerage services: a consultation

www.ofwat.gov.uk



About this consultation

This consultation examines the charging issues that the water industry faces and sets out our proposed strategy for future charges, as well as our updated charging principles.

We welcome comments on all areas of the consultation from the water industry, consumers and their representatives, and other stakeholders. We also welcome responses to the specific questions outlined here.

We will use your responses to inform the development of our future strategy. Please submit any evidence that you consider may be helpful to us in reaching our conclusions. We will take responses to this consultation into account and publish our final strategy in summer 2008.

Some of the issues discussed within this consultation (notably metering and the use of rateable value-based charging) are policy issues for the Government. This consultation is to inform Ofwat opinions and input into any future work on these issues.

Contents

Responding to this consultation	2
Executive summary	3
1. Background	5
2. Our updated charging principles and supporting strategies	9
3. Our policies	11
4. Impact assessment	26

Responding to this consultation

Please send responses to this consultation to Mandy Jones by **15 April 2008**.

You can e-mail your responses to mandy.jones@ofwat.gsi.gov.uk

or post them to:

Mandy Jones
Customer Charges Team
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory 'Code of Practice' with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Executive summary

The water and waste water sector provides services to consumers that are of fundamental importance to public health, the environment and wellbeing. Our job is to ensure that these services are provided in a way that protects consumers, promotes value and safeguards the future.

The sector faces a number of important changes and drivers ranging from the impact of climate change both in terms of mitigation and adaptation, questions of affordability and value in the face of increasing environmental costs and forecasts of significant and localised population growth with associated demands for increased services.

This document focuses on the development of customer charges for water and waste water services in this evolving world by building on our existing theme of cost-reflectivity. We set out some key strategic themes and invite views and comments from interested stakeholders on how these might be addressed. Our review of customer charging takes into account our developing approach to long term planning and sustainable development as set out in our PR09 methodology consultation. The development of individual company's 25-year strategic direction statements is also relevant as is the imminent publication of Governments' water strategies.

We have revised and updated the **principles** that underpin our decisions on charges by water companies to their customers. These principles are as follows.

1. **Fairness and equity** – customers who consume similar services in similar circumstances ought to pay similar charges. Charges should be broadly cost-reflective.
2. **Affordability** – water companies must have regard to the effects of their charging policies on different consumer groups, including potentially vulnerable consumers.
3. **Incentives to consumers and companies** – the right level of service should be provided at the right price, and charging systems should promote both the efficient use of water and sustainable development more generally.
4. **Simplicity and transparency** – companies should make it clear how their customers' overall bills are calculated and what customers can do to influence them.

Our strategy for customer charges needs to recognise a number of **evolving strategic themes** that include:

- encouraging the development and trialling of innovative tariffs and approaches to charging that increase customer choice, facilitate effective competition and reflect the circumstances in which water companies operate;
- support for a faster transition towards high levels of meter penetration, supported by sound cost benefit analysis (CBA) which identifies the potential for greater metering to facilitate the development of other benefits; and
- encouraging technological innovation.

We welcome your comments on the proposed principles and the key elements of our strategy.

In chapter 3, we have also set out a number of other areas for consultation. We welcome your feedback on these and other issues, not raised in this document, which stakeholders consider we should take into account.

1. Background

The Water Industry Act 1999 (WIA99) introduced a requirement for water and sewerage companies and water only companies in England and Wales to submit to us their annual charges scheme which sets out its charges to customers, for approval.

When we approve a company's charges scheme we check that the charges comply with the price limits we have set and that individual tariffs are not unduly preferential or unduly discriminatory to defined customer groups.

Companies cannot apply the charges in their charges scheme unless we approve them.

In relation to customer charging, our role is complementary to the roles played by other parties. Through primary and secondary legislation, government sets the policy framework within which Ofwat regulates. Our powers and duties enable us, as the independent economic regulator, to develop and implement charging policies within this framework. Companies are responsible for implementing and levying charges on customers. The table below summarises the key duties and powers of the various parties in relation to customer charges.

Table 1 Summary of powers and duties in respect of charges

Defra/Welsh Assembly Government (WAG)	Ofwat	Companies
May make regulations as to when companies can start fixing charges by volume.		Have the power to fix, demand and recover charges.
May give (published) guidance to Ofwat on the exercise of its power to approve charges schemes.	Has the power to approve charges schemes.	Must fix, demand and recover charges for domestic customers in accordance with a charges scheme which has been approved by Ofwat.
May make regulations as to provisions to be included in companies' charges schemes including: liability for specific charges, special provision for the purpose of assisting individuals such as exemptions for specified customers, alternative basis of charging, etc...	Must have regard to Defra's guidance in exercising the power to approve charges schemes.	May make a scheme that fixes charges for the period of a defined year, and determines times and methods of payment.
		May fix and calculate charges with reference to such matters, principles and methods they consider appropriate subject to the other provisions of the Act.
		Must make schemes that comply with any Regulations made by Secretary of State.
		Must set charges that comply with overall price limits.

Our charging strategy has evolved since we last consulted on our approach to approving charges in [MD152, 'Approval of company charges schemes 2000-2001'](#) (September 1999). We have taken account of the following changes in legislation, the regulatory framework and the industry working environment into our reactions to company charging proposals as we have approved charges schemes.

- The Water Act 2003 amended our regulatory objectives and duties so that we must now exercise our powers to “further the consumer objective ... wherever appropriate by promoting effective competition in the provision of water and sewerage services” but having “regard to interests of individuals who are: disabled, chronically sick, on low income, rural residents and customers not eligible for competition” whilst considering how best “to promote economy and efficiency, to secure no undue preference/discrimination and to contribute to the achievement of sustainable development”.

- Guidance from the Secretary of State for Environment, Food and Rural Affairs, issued in February 2000, commented on matters to be taken into account in the exercise of our powers to approve water companies' charges schemes.
- A cross-governmental review of water affordability in 2004 concluded that affordability would continue to be an issue for some lower-income water customers, and outlined ways to assist these customers.
- We and the industry are taking a longer-term view of the supply and demand for water resources at the 2009 price review (PR09) and charges will need to reflect this approach.
- There is an increasing need to consider climate change and future pressures on the water environment.
- More households have water meters and water companies are increasingly interested in trials of alternative tariffs.

In addition, we have also issued the following RD letters addressing individual issues as they have arisen, advising companies how we will treat proposals.

- [RD14/01, 'Approval of companies' charges schemes 2002-03 – tariff policy issues'](#) (September 2001).
- [RD16/02, 'Intermediate user tariffs – conclusions'](#) (May 2002).
- [RD05/03, 'Tariff policy issues'](#) (February 2003).
- [RD09/03, 'Special agreements'](#) (March 2003).
- [RD25/03 'Proposed modification of licence condition B'](#) (June 2003).
- [RD30/03 'Measured/unmeasured tariff differential'](#) (August 2003).
- [RD31/03 'Non-household tariff policy issues'](#) (August 2003).
- [RD35/03, 'Surface water drainage – charging policy'](#) (September 2003).
- [RD02/04, 'Measured/unmeasured tariff differential: conclusions'](#) (January 2004).
- [RD13/05 'Charges to vacant properties'](#) (July 2005).
- [RD02/06 'Charges to vacant properties: conclusions'](#) (March 2006).

We consider that it is now timely to review our overall charges strategy and to bring it into line with our broader objectives of protecting consumers, promoting value and safeguarding the future.

A number of other issues are likely to have an impact going forward. We will take these into account where appropriate when finalising our strategy. These are listed below.

- The Department for Environment, Food and Rural Affairs (Defra) and WAG are due to publish their water strategies in early 2008. This will set out their long-term visions for the water sector, including the water industry.

- In early 2008, we will receive the results of customer research (commissioned by us and CCWater) into fair charging, including consumer attitudes to cross-subsidies and alternative tariffs.
- We will also receive the conclusions of research, undertaken during 2007, into the impacts of alternative tariffs on groups of customers. This research was commissioned by us, Defra, and UK Water Industry Research (UKWIR).
- The water companies' strategic direction statements (SDS) provide a view of where each company expects to be in 25 years' time. These are now [published](#) and set the context for each company's approach to the 2009 price review.
- Our review of competition and cost allocation project, which are currently under way, will impact on tariffs as more accurately allocated costs are fed through into more cost-reflective tariffs.

We will take account of these issues in our response to this consultation.

In chapter 1 of the supporting information we examine the how customer charges fit with the wider context.

2. Our updated charging principles and supporting strategies

We have updated our charging principles in the light of the changes outlined in chapter 1. The principles will guide how we approach water companies' future charging proposals.

2.1 Charges should be fair and equitable

Customers who use similar services in similar circumstances should pay similar charges. Charges should be broadly cost-reflective. We do not envisage cross subsidies across company boundaries. Any differences in charges should properly reflect differences in the efficient costs of water supply and sewage disposal.

To support this principle, our policies will:

- ensure that companies make their charges more cost-reflective and transparent, taking into account the costs and benefits of doing so; and
- encourage and support long-term planning for increased metering and a variety of tariff options that meet consumers' needs.

2.2 Charges should be as affordable as possible for all customers

Each water company operates as a monopoly in its own area and most customers cannot choose their suppliers. We have a duty to protect consumers, and so will make sure that each company is aware of the effects its charging policies have on different consumer groups, including potentially vulnerable customers.

To support this principle, our policies will expect companies to take account of the needs of vulnerable customers.

2.3 Incentives to consumers and companies should be improved

We want companies to deliver the right level of service at the right price. This will help to promote both the efficient use of water and sustainable development more generally. It will also encourage innovation and alternative tariffs, which can increase customer choice and cost-reflective charging.

To achieve this, we will:

- encourage companies to use innovative tariffs and new technology to deliver benefits for all stakeholders;
- allow each company to design tariffs that meet the needs of its customers in the context of its own circumstances and overall SDS; and
- encourage companies to deliver a range of choices that customers understand and that reflect their needs.

2.4 Companies should be clear about how customers' overall bills are made up and what customers can do to influence them

Customers need information to understand their bills and how the amount of water they use influences the charges they pay. This should enable customers to better understand how their bills might change in the future and to act appropriately, either by changing how much water they use, or by choosing a different tariff or means of charging. With the potential development of competition in the future it should also help customers choose which services to buy from which supplier.

We will make sure that charges:

- are structured to promote and enable competition to develop; and
- make clear connections between use and cost.

3. Our policies

In order to implement the updated charging principles our approach to charges will be open and proactive. We are keen to encourage innovation and will seek opportunities to work with companies to develop tariffs that could increase customer choice and meet customers' needs. For PR09 we will seek to strengthen the links between charges, sustainability and supply/demand balance policies. This document sets out some of the key issues for the future, with the purpose of ensuring that our charging principles are reflected as companies' charges evolve.

3.1 Unmetered charges

At present, two-thirds of household customers in England and Wales do not have water meters and are charged on an unmetered basis. Recent joint research by ICF for Defra, Ofwat and companies is expected broadly confirm previous findings, ("Paying for Water – the way ahead" Ofwat 1991), that any change to an alternative to the current rateable value (RV) basis of unmetered charging would mean that large numbers of people could see significant increases or decreases in their bills. However these changes would not be objectively linked to water consumption.

Our view is that although using RVs as the basis for charging is not perfect, it is the best option available for unmetered customers. Based on evidence to date and recent amendments to regulations in England¹ to extend the powers for companies in areas of serious water stress to install meters, we expect that the number of customers without meters will fall substantially in the future. We therefore consider that it would not be a good use of resources to promote any change from the RV system to any other unmetered charging system as it would not deliver benefits. While the RV system will become increasingly outdated, we consider that it will remain serviceable for those who continue to be charged by it in the medium term. Instead, we consider that it could be more productive to concentrate on the increasing penetration of meters and the development of alternative volume-based tariffs.

We acknowledge that the RV system offers an element of social protection for some lower-income customers in low RV properties. This is because lower-income households are more likely to occupy properties with lower RVs, and are less likely to be paying an amount which more fully reflects how much water they use. This is most likely in the case of larger households. Smaller households in properties with higher RVs will pay more than would be the case if they had a meter and, as a result,

¹ http://www.defra.gov.uk/environment/water/industry/water_metering/pdf/govt-response.pdf

they subsidise lower-income households. However, these households are those most likely to opt for metered charges so the extent of this 'social protection' is progressively falling. We consider that as meter penetration increases there will be an increasing need for companies to offer alternative tariffs as a safety-net for vulnerable customers.

In MD165, 'Approval of company charges schemes in 2001-02' (September 2000), we stated that we would look critically on company proposals to increase charges for customers on low rateable values through changes to "RV modifiers". These are the standing charges that apply on unmetered bills in most water company areas. Where the RV modifier increases over time, a customer must use progressively more water to remain better off on unmetered than metered charges, and could increase unmetered bills to the extent that customers on low incomes may find their ability to pay compromised. We propose to retain our position. Where companies wish to agree RV modifiers in order to encourage take up of metering, we will expect alternative tariffs or mechanisms to be available to protect vulnerable or low-income customers who may be affected.

Unmetered charges

We propose no replacement for the current RV charging system for unmetered customers.

Would you support 'no change' to the current RV unmetered charging system:
i) under the current metering rates (shown in section 3.2 below)?
ii) under a programme that delivered higher levels of metering earlier?

What factors could make RV charging unsustainable and what other alternatives do you think should be considered?

Do you agree with our approach to RV modifiers? If not, please explain the basis of your preferred approach.

3.2 Metering

Companies have some leeway to influence the rate of meter uptake within currently prescribed regulations but any changes to these regulations lie with the Government. We believe that increased metering is crucial to the implementation of key changes in water charging, notably, the development of innovative, volume based tariffs.

Meters are the fairest and most transparent way of charging customers, as costs are based on the volume of water used. Metering allows companies to tailor their tariffs to best suit their customers' needs and to reflect the costs customers impose on the supply system.

In addition, metering should facilitate the development of sustainable competition for a wider customer base in the future. The improved price signals that can be developed through metering can not only send signals to customers but can also reveal where entry would be most profitable and sustainable. Metering would also enable alternative water suppliers to offer differing tariffs and service levels.

Whilst we recognise there can be significant benefits from increased metering there are also additional costs. If virtually universal metering were to be in place by 2030 we estimate it could raise average household bills by about 2.2% more than would have been the case under the PR04 metering projections.

The historic patterns of metering levels and companies' forecasts until 2029-30 based on information from PR04 are shown below.

Table 2 Household metering projections

% metered household properties	Actuals (%)				Projected (%)				
	1992-93	1995-96	1999-00	2004-05	2009-10	2014-15	2019-20	2024-25	2029-30
Anglian & Hartlepool	4	14	42	54	60	71	79	84	87
Dŵr Cymru	3	3	7	19	32	42	51	58	64
United Utilities	2	5	9	17	26	37	46	54	60
Northumbrian (North East)	1	2	5	11	19	26	32	38	43
Northumbrian (Essex & Suffolk)	2	7	23	35	47	58	63	67	71
Severn Trent	5	9	17	24	30	36	40	45	49
South West	4	8	23	46	65	77	84	89	92
Southern	10	11	18	27	42	53	62	68	72
Thames	2	4	16	20	27	41	50	56	59
Wessex	5	10	23	33	45	54	61	68	75
Yorkshire & York	3	7	18	27	34	42	49	55	61
Bournemouth & W Hampshire	3	6	18	37	50	64	75	82	87
Bristol	3	7	14	23	30	36	41	44	47
Cambridge	5	11	42	54	59	68	74	79	83
Dee Valley	4	8	20	34	44	53	60	66	71
Folkestone & Dover	3	11	29	41	67	93	94	94	94
Mid Kent	3	7	18	33	44	55	65	70	75
Portsmouth	0	0	1	5	12	20	27	33	40
South East	4	10	21	29	38	46	53	59	65
South Staffordshire	3	5	9	15	21	26	29	32	35
Sutton & East Surrey	1	4	12	19	27	32	38	43	47
Tendring Hundred	5	10	33	61	69	75	81	85	88
Three Valleys	3	5	14	23	42	61	72	78	81
Water and sewerage companies	3	7	17	26	35	45	53	58	63
Water only companies	3	6	15	25	36	48	55	60	64
South east¹ companies	3	6	16	22	33	46	55	61	65
Industry total	3	7	17	26	35	45	53	59	63

Note:

1. South east companies: Southern, Thames, Folkestone & Dover, Mid Kent, Portsmouth, South East, Sutton & East Surrey, Three Valleys.

Companies can draw on the breadth of information available to them to identify the scope of the cost benefit analyses needed to reflect the full extent of benefits that increased metering can deliver.

Additional costs would be incurred if the RV system were to be replaced. Accelerated progress towards metering could reduce the likelihood of a replacement to the RV based system being required. The costs of implementing a new system would be significant and should be recognised as a factor in any cost/benefit assessment for accelerated metering.

Companies need to take the indirect benefits of metering into account, both in the costs that these may save and other associated impacts such as climate change. For example, pumping costs may fall as a result of having to deliver less water, leading to a lower carbon footprint. Around a quarter of energy use in existing homes (up to 60% in small flats) is used to heat water for showers, baths and hot water taps (excluding the energy used to heat water in kettles, washing machines, dishwashers and central heating). Domestic hot water use contributes about 35 million tonnes of carbon dioxide a year – more than 5% of the UK's total greenhouse gas emissions. At an individual level, if consumers are more aware of the cost of water because they pay by for the volume they use, any choice to use less may reduce both the amount of water used and the energy required to heat it, providing a double benefit in carbon reductions.

Metering levels vary between companies, with meter penetration ranging from 11% to 67%. Companies' SDSs provide an updated their view of how they anticipate metering levels will change over the next 25 years. Almost all companies expect metering levels to significantly exceed the levels forecast for equivalent years at PR04. Several companies expect to see virtually universal metering well within the 25-year planning horizon. Each company will have a metering strategy suitable to its own circumstances and we accept that these will vary.

Our strategy will be to support more rapid progress towards high levels of meter penetration based on the work that companies must do in their water resource plans and the proposals they may make in their SDS.

Companies can already install meters in properties when occupancy changes and under a limited range of other circumstances set out in the Secretary of State's prescribed conditions regulations 1999. We would encourage each company to use the opportunities available to it to expand metering in its area as far as is economically practicable. Where a company's area has been designated an area of water stress, for example, we consider it essential that metering should be used to its fullest extent. This will enable the company to encourage more customers to reduce their water use for environmental or financial reasons, while giving customers the choice to receive a level of service for which they are prepared to pay.

We accept that more metering could lead to less customer choice in the short term, if unmetered customers lose their right to remain without a meter. And some customers would see increased bills if they are compulsorily metered. However, we consider that in the long term more metering will provide customers with greater choice through the development of a range of tariff options. (These are further discussed in section 3.6.) These options should include tariffs that offer protection for vulnerable and low-income customers.

Paying for metering

We will support accelerated metering programmes. We have set out our current understanding of the cost of metering.

What are the other issues and evidence that we should consider to gain a better understanding of the costs and benefits of accelerating the uptake of metering?

We accept that each company will differ in its estimate of the optimum timescale for universal metering.

What are the factors which you consider should determine when universal metering becomes appropriate?

3.3 Metered standing charge

Customers who are currently using meters are generally on a simple metered tariff with a fixed standing charge and a variable volumetric charge. We consider that this structure provides a useful starting point unless there are reasons to pursue actively additional net benefits from introducing more complex tariffs.

The costs that drive the standing charge and the volumetric charge should be considered carefully. We do not currently impose limits on standing charges, but address company tariff proposals individually. There is currently a significant range in the level of standing charges across companies. Making sure that these charges accurately reflect the customer-related and volume-driven costs of the service respectively would be consistent with ensuring that tariffs are structured so that they promote competition. This is because it will be clear to entrants where they may be able to provide services more efficiently than the incumbent company.

In addition, this tariff structure, if correctly reflecting all costs, should reveal the value of water and allow customers to use water based on their perception of that value – that is, they can reduce their bill by using water efficiently or use more if they are willing to pay for it.

Each year, we ask companies to check that the difference ('the differential') between metered and unmetered bills, on average, reflects only the differences in cost of providing a metered service.

Each company has a target for 'the differential', although we offer flexibility on a case-by-case basis. Whilst we remain committed to this approach we need to ensure that the costs included within the differential are consistent and complete.

Metered standing charges

We propose to consider again how metered standing charges should be structured.

How should metered standing charges ideally be constructed to accurately reflect the customer and volume-driven costs while also enabling competition?

3.4 Cost reflectivity

It is increasingly important that each company can publicly demonstrate the link between the charges it sets for particular services and the underlying costs. This lets customers see what they are paying for and therefore make informed choices that in turn can deliver on policy objectives such as using water wisely and reduced carbon impacts. It will also help to guard against anti-competitive behaviour by incumbents and improve cost transparency for services not directly open to competition. However, we do not expect companies to look to unwind cross-subsidies inherent in the current charging framework at present.

Tariff structures should reflect the issues facing the business and be part of each company's choice of solutions. We stated in our [PR09 methodology](#) that companies should explain how they will use pricing signals to help manage the demand for water.

These types of tariffs should focus on enabling customers to pay charges that reflect the costs they impose. The choices customers make in response to particular prices will reveal their willingness to pay for their chosen level of consumption, or their wish to control their bills. Companies should factor these responses into their investment decisions.

We will encourage and approve trials of new pilot tariffs to understand the effect of the tariffs on customers' choices. We set out below our proposed approach in relation to two specific types of metered tariffs – seasonal tariffs and rising block tariffs.

3.4.1 Seasonal tariffs

Companies that have critical period resource issues identified through their security of supply index will be required to develop seasonal tariffs and to propose appropriate trials, over the next five years. We also support trials by others companies that wish to identify future potential benefits from seasonal tariffs. We stated in our PR09 methodology that companies will not be funded for expensive supply/demand schemes unless they can show that they have already considered tariff development as an option. These tariffs send a clear demand-based message since the customer pays more for water that is most expensive to supply. Customers would have the choice to control how much water they use if they wish to reduce their bills, or to pay the increased costs for discretionary use of water at peak times.

The new revenue corrected price cap to be introduced through the price review from 2010 will help to remove any short-term disincentive that may have discouraged companies from implementing such tariffs in the past because they did not wish to lose revenue.

These tariffs could be expected to reduce the growth in metered water demand and significantly reduce bills for some customers, while making sure that those who do not wish to modify their usage or reduce the amount they use cover the costs that they impose.

We consider that the cost of sewerage services should not rise simply because the cost of supplying the water rises. We retain our position that charges should be broadly cost-reflective, including keeping the costs of supplying water and sewerage separate.

3.4.2 Rising block tariffs

These tariffs focus on incentivising customers to use less water throughout the year. They might be attractive to companies whose costs are driven by rising demand that wish to encourage water efficiency. They may be unlikely to be as cost-reflective as seasonal tariffs and will have varying effects in reducing the growth in demand, depending on the structure of the tariff.

Tariffs can be structured so that the first block of water is free or provided at low unit cost. Blocks can rise in price according to how much water is used. The initial block

volume can be linked to non discretionary or “essential” usage. It is critical that the construction of this block is carefully considered in relation to what the company hopes to achieve through the rising block tariff and any requirements for household specific information. These tariffs may offer opportunities to protect low-income and low-user groups, if the blocks are designed appropriately.

We note that there could be logical reasons for linking the sewerage charge to the increasing blocks and would welcome views on this when companies present tariffs for consideration.

3.5 Tariff trials

We will encourage and support the use of trials that can provide the strong evidence to inform the development or refinement of tariffs to address individual company issues and broader industry objectives.

Such trials need to have well-defined objectives, timescales and data collection requirements, and identify the potential adverse impacts on some customers. Trials of tariffs will be most effective when imposed on groups of customers, rather than run on an optional basis. This will maximise the value of data that is collected in the trial, as it will illustrate how customers of all types respond to the changing prices. Trials that are run on an optional basis only will be most attractive to customers who believe they will benefit from the tariff. That is not to say that once a trial has been run the tariff could not be rolled out to groups of customers on an optional basis, if that were appropriate. However, companies would have to consider the impact this might have on other groups of customers, whose tariffs may have to be rebalanced accordingly.

Tariff trials must be included in an approved scheme of charges before companies can put them into operation.

Tariff trials – gaining the evidence

Encouraging innovative tariffs is a key element of our strategy.

We will continue to look favourably on proposals from companies to develop a range of innovative tariffs. We will approve cases for trials as a basis for considering whether we should press for greater adoption of such tariffs in the future.

To what extent have these issues been explored by companies up to now and what evidence is there that could be taken into account when assessing options?

What are the issues involved in setting up and running successful tariff trials as a way to obtain sound and timely information in support of new household tariffs?

Are there incentives that could be offered to companies to share the results of robust early tariff trials?

3.6 Innovative tariffs

We intend to encourage the development of innovative tariffs in both water and sewerage (including drainage) and will work with companies to facilitate effective trials of suggested tariffs. These do not need to focus only on incentives to use less water, they can address other issues. For example, there may be tariffs that could affect debt and affordability issues, or the potential likelihood and extent of flooding, and we will consider these in the same way as other proposed tariffs. We will be open to suggestions that do not rely only on the current methods of charging, but might involve the use of other data or systems, should they be practicable.

We will continue our current checks on proposed tariffs in order to make sure that they are structured soundly and that they do not contravene condition E of the companies' appointment, but with an aim to ensure that they can be taken forward effectively. We will be keen to see suggestions for tariffs that could both increase incentives to customers and address affordability issues.

Innovative tariffs

We will encourage the development of a range of alternative tariffs, and will consider the arguments for whether each should be imposed or made optional.

What are the issues each company must take into account when assessing whether to impose a tariff or offer it as an option? Where should the balance lie in offering innovative tariffs and protecting customers who are not on those tariffs?

What other types of optional tariffs could be developed, beyond those considered in this consultation, and what might their impact be (for example, interruptible tariffs for large users)? How do they meet the objectives we have set out for the development of future tariffs and charges?

How far do we need to regulate the level of charges set under optional tariffs so long as other customers continue to be protected?

3.7 Affordability and social tariffs

Protecting consumers is one of our primary duties. In this context, making sure that companies keep prices as low as possible, whilst reflecting longer-term considerations, is the best way to address affordability.

Where individual tariffs are concerned, increased cost-reflectivity of charges can be at odds with social and environmental objectives. Social tariffs seek to protect some customer groups from paying the full underlying costs of the services they receive. Environmental objectives could encourage companies to set volume-related charges that are unjustifiably high compared with the underlying costs in order to drive reductions in consumption.

Consumers have indicated² that they support two elements of cross-subsidy that already exist in the charging system. The vulnerable groups tariff, which has been driven by government policy and sets out the protection to be offered to metered consumers in certain circumstances, regardless of the local nature of the supply they receive, where they live or which company supplies them. The other is the

² Deliberative research into consumer views on fair charging for the Consumer Council for Water, 5 February 2007.

rural/urban cross-subsidy, which spreads costs evenly across company areas. We will continue to protect customers by not seeking to unwind these cross-subsidies.

We retain our belief that it is appropriate that Government should take responsibility for deciding who should be protected from unavoidably high water bills on a national basis through cross-subsidies. We also continue to believe that it is the Government's role to protect vulnerable or low-income customers through the tax and benefits system, rather than expecting this to be addressed in water charges by additional cross-subsidies from better-off customers. However, local water companies will be in a position to know how additional protection could be targeted at customer groups in their own areas without increasing costs to other customers.

We have a duty to protect all customers. We believe that it is possible to develop tariffs that protect vulnerable and low-income customers without unduly increasing the burden on other customers through cross-subsidy (for example, where the number of customers helped may be small and the burden spread across a wide customer base). We will encourage these tariffs and work with companies to help develop them through approved trials. Such solutions might include tariffs that also offer increased incentives to make and maintain manageable payment arrangements. Some companies are already trialling, or preparing to trial, similar tariffs. Going forward, tariffs that increase protection to customers will become more necessary if environmental issues such as the cost of carbon are built into tariffs; we expect company proposals for innovative tariffs to reflect this.

The existing ban on household water and sewerage disconnection was introduced in 1999. Since then companies have seen a 43% rise in the level of debt that has been written-off as unrecoverable. This ban will continue to influence the likelihood that some customers choose not to pay their bills for these services, particularly when weighed against the threat of disconnection of other energy and telephone services.

Given this rise there is an argument that water debt could be reduced if the disconnection ban were relaxed (subject to suitable controls to protect customers who genuinely have difficulty in paying) or the use of pre-payment meters or trickle flow devices in this context reassessed. It has also been suggested that the capacity of companies to collect charges from all of their customers under the current law should be evaluated; such a review could lead to new legislation to fill gaps. This might include a definition of the term 'occupier', which currently governs which individuals the companies can charge.

These issues are largely a matter for Government and are outside the scope of this consultation but we will continue to work closely with Defra and other Government departments on these very important issues.

3.8 Assessed charges

Companies can offer an assessed charge to customers who cannot have a meter installed because it would be impractical or unreasonably expensive to do so. When this policy was initially introduced, many companies opted for an average charge, but recently most have introduced more sophisticated tariffs. These tariffs attempt to provide an indication of how much water consumers use either by basing the charge on estimated usage or the number of bedrooms in a property. Only three companies now use average charges, two of which offer a single occupier discount.

We believe that the availability of assessed charges is a valuable protection for customers with an RV that does not represent their water use, but who cannot have a meter installed. We will expect companies to offer assessed charges that aim to more closely reflect individual household use.

3.9 Sewerage charges: surface water drainage

All companies now offer a bill reduction for customers who can show that they are not connected to the surface water drainage system. However, for four of the ten water and sewerage companies, non-household customers are still charged for surface water drainage according to:

- their RV;
- a flat fee (in the standing charge or separately by property type); or
- a charge that is included with their volumetric rate for sewerage.

We believe that these charges should better reflect the actual costs imposed on the system by customers, and that the use of site area drainage charges is the most effective way to achieve this. We propose to require the six sewerage companies that do not currently use this type of tariff to produce plans for phasing in such a tariff for non-household customers. We accept that collecting the necessary information can mean relatively long lead times, and we expect that companies would propose phasing of the new charges to protect customers from large incidence effects.

3.10 Customer choice

We hope that our cost allocation work, (outlined in chapter 1 of the supporting information), will encourage each company to develop a better understanding of how tariffs can be designed to increase customer choice. This should encompass options

for both household and non-household customers. We would accept greater use of special agreements as a means of developing more consumer-focused tariffs.

We think companies should have a route to offer optional tariffs as an alternative to standard tariffs. An example of such a tariff could be an optional higher cost 'green' tariff. Companies would have to be able to demonstrate that customers who remain on 'core' tariffs would not be unduly disadvantaged and that justified elements of cross-subsidy could be protected. We think companies should continue to be required to justify the basis for charging levels under such optional tariffs.

3.11 Non-potable charging

The charging principles of fairness and equity support the averaging of costs across large numbers of customers connected to well-integrated networks.

Non-potable supply networks are often less integrated than potable supply networks. Our charging principles support a more locally reflective consideration of the costs and/or a more granular approach to regional average costs.

Non-potable charges

Non-potable tariffs are emerging as a developing area for charging.

How should non-potable charges fit with the principles of geographically averaged charging whilst taking into consideration the potential differential use of specific water supply functions (ie, possibly more limited use of service reservoirs, pumping, distribution, etc)?

3.12 Technological innovation

Tariffs have a part to play in driving or contributing to technological change. We will encourage innovative house-based solutions to resource and other issues, such as rainwater harvesting and grey water recycling. We will also expect each company to adopt appropriate policies on charging, metering and non-return to sewer to encourage these solutions.

We also look to companies to consider the benefits for customers and companies of smart metering. They could enable the efficient operation of alternative tariffs and

potentially allow customers access to detailed information about their bills and water use on which to make informed choices on tariffs and behaviour. We will encourage companies to identify the uses for, benefits and costs of smart meters in their plans and to set up associated trials. This includes looking at differences in costs of installing new smart metering in new developments and retrofitting smart meters to existing metered customers. Companies should also consider how new tariffs could be implemented without the need to fit smart meters in some cases. Companies should seek to draw on the developments in other sectors to identify potentially beneficial applications, equipment and software.

4. Impact assessment

In chapter 2 of the supporting information we include an interim assessment of the potential impact of our policies. We welcome views on the completeness and quantification of the costs and benefits that have been identified.

We will use this to develop an impact assessment in line with our published framework.



Ofwat, Centre City Tower
7 Hill Street, Birmingham B5 4UA

Phone: 0121 625 1300 Fax: 0121 625 1400
Website: www.ofwat.gov.uk
e-mail: enquiries@ofwat.gsi.gov.uk

January 2008

© Crown Copyright 2008