

Issues for consultation in the pricing section of the access codes guidance

In October 2007 we received water undertakers' (appointed water companies) 2007-08 published indicative access prices under the water supply licensing (WSL) regime together with supporting information. We reviewed that information and highlighted the main points of our analysis in our December 2007 Competition Review part 1 paper. In March 2008, we made our first determination under section 66D of the Water Industry Act (WIA91) in relation to wholesale prices. In May 2008 we completed our competition review, which included further thoughts on the level of the volume threshold for business user competition. In the light of that work, we consider it would be appropriate to revise our access codes guidance (ACG) according to section 66F(6) WIA91.

In summary, we propose to:

- make our pricing guidance more prescriptive about the costs and expenses that should be included when appointed water companies calculate their indicative access prices;
- clarify our guidance about how the cost of credit for licensees should be calculated for case-specific access prices;
- amend the breakdown of retail cost information that we request from water companies; and
- clarify our guidance regarding economies of scale savings when more than one customer switches to a particular licensee from the same water company.

We also considered that some minor text changes are necessary to make parts of the ACG clearer and that the structure of the document should be made easier to follow. The proposed changes set out in this document should be read alongside the amended version of the pricing section of the ACG that accompanies this document. For ease of reference, new text has been highlighted (apart from alterations to table and chapter numbering).

Overview of proposed changes

1. Costs and expenses elements of the access price calculation

Section 66D(3) WIA91 provides that the charges payable by a licensee to a water undertaker under a WSL access agreement or determination shall be fixed in accordance with the costs principle, set out in section 66E WIA91. The costs principle is prescribed by statute as the basis on which access prices under the WSL regime must be calculated. The costs principle prescribes a 'retail-minus' approach to

pricing. Any amendment to the costs principle could only be made by primary legislation.

In general, appointed water companies should apply the 'retail-minus' approach as follows:

Access price = any expenses reasonably incurred + retail charge – ARROW costs

ARROW costs are expenses that can be avoided or reduced; or any amount that is recoverable in some other way (other than from the water company's other customers).

Our present ACG allows water companies a considerable degree of flexibility as to what costs and expenses are included in these elements. The indicative access price should, however, be the price that any licensee can expect for any wholesale supply to any customer. Therefore, we propose to provide more prescriptive guidance on the costs and expenses that a water company should include in its calculation of indicative access prices. This should not prevent case-specific prices including higher discounts than the indicative price. A case-specific price that included a lower discount would need to be strongly justified. The revision is appropriate because it will enable potential entrants to assess more accurately the opportunities for wholesale or combined access in a particular water company's area.

2. Cost of credit for licensees

The cost of credit that a water company incurs when serving a licensee should be lower (by a relatively small amount) than the equivalent cost of credit for dealing with a customer. That is because the licensee owes less to the water company than the customer would have done for the same quantity of water supplied, due to the access price discount. This is retail activity R11 in the ACG.

3. Breakdown of retail cost information

We propose to simplify table 14 (formerly table A3.1) in the ACG relating to retail ARROW costs and customer numbers.

The customer cost categories of ≥ 5 MI and < 10 MI/yr, ≥ 10 MI and < 20 MI/yr and ≥ 20 MI and < 50 MI/yr would be amalgamated into one cost category of ≥ 5 MI and < 50 MI/yr.

Most respondents to our July 2007 consultation paper believed that the volume threshold should eventually be zero (i.e. a market of all non-households), but there were mixed views with no specific industry divisions as to whether this should be

achieved by one or more revisions to the WSL regime. In our competition review consultation papers published in December 2007 and May 2008, we explained that we would like to see a stepped reduction in the volume eligibility threshold, first from 50 MI to 5 MI, then from 5 MI to 0 MI. Responses to the July 2007 paper also raised the potential problem of households being eligible to switch by virtue of their being part of mixed-use premises (e.g. the flat above a shop, both of which share a single supply to the 'premises'). We consider that a larger market will reveal more information about retail costs, particularly if more customers switch. In advance of the reduction in threshold to zero, we will need to have robust cost information about smaller non-household customers such as newsagents, general stores, etc., who would be then be eligible to switch supplier. In the current version of the table, we ask for retail costs for non-household customers using less than 1 MI of water per year. We considered amending the cost categories of table 14 to ask for cost information for non-household customers who used less than 100m³ (0.1 MI), but it is unclear whether that division would capture the eligible non-household customers, but exclude households that are part of mixed-use premises. In this consultation, we are asking for consultees' views about how we can accurately gather the cost information necessary to administer a regime without a volume threshold.

Table 14 currently asks for the ARROW costs for one 50 MI/yr customer and one 500 MI/yr customer. In addition, we propose to ask for the ARROW costs if 100% of a company's eligible customers were to switch to a licensee. We can use this data to compare with the column in table 18 (formerly table A3.2), requesting the expenses of serving a licensee which is itself serving 100% of the eligible customers.

4. Economies of scale savings

We consider that as customers switch and a licensee gains more customers, so the access price that the appointed water company offers should reflect savings realised by that company from economies of scale that would arise from having multiple customers served by a single licensee, instead of serving each customer individually. The access price for a switching customer should reflect the net saving because of the economies of scale at the point that the customer switches. We consider that the net saving at the point of switching is appropriate because over time some customers may switch back. It would also be impractical to change previously agreed discounts for early switchers to reflect new savings or costs from recent switchers.

Proposed revisions to the access charging guidance

Proposal 1: We want indicative access prices to be the price that any licensee can expect for any customer. We consider this is appropriate because it will enable potential entrants to assess more accurately the opportunities for wholesale or combined access in a particular water company's area.

We propose to revise our guidance on the different retail cost activities that make up the ARROW costs element of the access price calculation in the following ways.

- Activities R1 (customer billing), R2 (meter reading), R3 (maintenance of customer account information), R4 (payment handling) and R10 (account management activities) should be assumed to be no longer required by the customer from the appointed water company. Water companies should use case-specific information for the frequency and type of services that they currently provide to the customer to assess the avoidable cost for the access price to the licensee. If these services are provided directly to the customer (i.e. the water company has not outsourced a particular function), the avoided costs should reflect the full overhead allocation. If an external third party provides the water company's services, the costs avoided should reflect the terms of the contract between the water company and the third party.
- Activity R5 (handling and resolving customers' calls, correspondence and complaints) will be reducible. For a licensee with a single customer, we would expect these costs to be reducible by at least 50%. If a licensee has more than one customer, the overall proportion of costs that are reducible should be greater than 50%. Once a customer has switched, the licensee will handle the majority of contacts with that customer. The water company may have to provide information to the licensee and should provide reasons for the proportion of these costs that it considers is avoidable or reducible.
- The costs of R6 (debt collection and recovery procedures) should be avoidable in full, because licensees will be responsible for the recovery of debt from their customers.
- The costs of R7 (doubtful debts) should be reducible. Water companies' liabilities for doubtful debts will reduce as customers transfer to licensees. They should allocate the value of this reduced liability to the licensee. If a licensee has switched a single customer, the avoided costs should reflect the access price discount. For a licensee that has switched two customers, we consider that 50% of these costs should be avoidable because the water company would be dealing with one licensee, rather than two customers.
- The costs of R8 (advice on water efficiency and quality) should be avoidable in full. Water companies have a duty to promote the efficient use of water by all their customers. This duty applies equally to licensees, who will assume full responsibility for the service (and the cost) once a customer has switched.
- The cost of R9 (sales, marketing and provision of information to customers) should be avoidable in full because licensees will provide sales and marketing information once a customer has switched.
- Licensees are not eligible for GSS payments. Once a customer has switched to a licensee, the cost of any payments likely to be made to that customer should be avoidable in full.

- Licensees will bear the cost of providing customer credit (activity R11). Therefore, the water company will avoid these costs in full.
- The 'other' costs included within R12/R13 categories (leak detection work, for example) cover activities that would be the responsibility of the licensee to provide once a customer had switched. This means these costs should be avoidable in full.
- Costs included within category R14 (competition-related capital maintenance charges) could be the costs of improving or updating the hardware for customer-facing systems. If water undertakers share this hardware with other non-appointed businesses, there may be costs that are recoverable in some other way.

Water companies currently have a relatively free rein to decide what level of service they would give to a licensee and hence the expenses associated with those activities. We consider that only the following activities constitute a minimum service to the licensee:

- R1 (licensee billing);
- R2 (meter reading);
- R3 (maintenance of licensee account information);
- R4 (payment handling); and
- R5 (handling and resolving licensee's calls, correspondence and complaints).

Water companies should not include any other retail activities in their assessment of the expenses of serving a licensee.

Question 1: Do you agree with this proposal? If not, please explain why and state any alternative proposal that you consider would be preferable.

Proposal 2: We consider that the formula below should be used to calculate the cost of credit for serving a licensee.

$$R11 = \text{time (number of days between billing date and the contractual payment date/365)} \times \text{annual interest rate} \times \text{amount of bill for licensee}$$

Question 2: Do you agree with this proposal? If not, please explain why and state any alternative proposal that you consider would be preferable.

Proposal 3: We propose to simplify table 14 (formerly table A3.1) to include the revised customer categories already described. The proposed template for this table is shown below.

Revised table 14: Retail cost analysis

Ref.	Retail activity	Costs (£) driven by:								ARROW costs (£) for 1 customer of 50Ml p.a.	ARROW costs (£) for 1 customer of 500Ml p.a.	ARROW costs (£) - 100% of eligible customers lost
		all sewerage customers (WASCs only)	all water customers	all unmetered water customers	all metered water customers	Water customers >=50 Ml p.a.	Water customers >=5 and <50Ml p.a	Water customers >=1 and <5Ml p.a	Water customers <1Ml p.a			
R1	Customer billing											
R2	Meter reading											
R3	Maintenance of customer account information											
R4	Payment handling											
R5	Handling and resolving customers' calls, correspondence and complaints											
R6	Debt collection and recovery procedures											
R7	Doubtful debts											
R8	Advice on water efficiency and quality											
R9	Sales, marketing and provision of information to customers											
R10	Account management activities											
	GSS payments											
R11	Cost of customer credit											
R12	Other services provided to eligible customers											
R13	'Other' retail costs											
R14	Competition related capital maintenance charges											
R15	Total ARROW costs											
	Total costs									-	-	
	Number of customers									1	1	
	Volume of water supplied (Ml/yr)									50	500	

Note: * Specify cost year (eg, 2007-08) and price base (eg, 2007-08).

Question 3a: Do you agree with the proposal to change the cost data requested in table 14? If not, please explain why and state any alternative proposal that you consider would be preferable.

Question 3b: Do you have any suggestions for an appropriate method to collect the cost information necessary to administer a future regime for non-households without a volume threshold?

Question 3c: Do you have any initial thoughts about how to differentiate between genuine non-household premises and households that form part of mixed-use premises, to ensure that only eligible customers could switch supplier?

Proposal 4: We propose to add the highlighted text on page 15 of the amended pricing guidance. This text reflects our view that the case-specific access price offered to a licensee by an appointed water company should include any net savings at that point from economies of scale achieved by having more than one customer served by that same licensee.

Question 4: Do you agree with this proposal? If not, please explain why and state any alternative proposal that you consider would be preferable.

Proposal 5: In addition to the other proposals outlined in this document, we have made some minor changes to the text in the guidance to, for example, increase the clarity of worked examples or make clearer our information requirements. Text that has been added or amended since the July 2007 version of the ACG has been highlighted. These minor text changes include:

- an explanation of the price base to be used when populating tables;
- clarification of the information that appointed water companies are required to submit with their indicative access prices; and
- adding text and tables to make the worked examples of access price calculations easier to follow.

We have also made changes to the structure of the pricing chapter of the ACG.

In the current version of the ACG, the methodologies for calculating case-specific and indicative access prices are contained in appendices. This makes the document more difficult to use and understand because the 'how-to' elements of it are separate from the explanation of the principles behind access prices.

As a result, we propose to change the structure of the pricing guidance so that the explanation of the calculation of the case-specific and indicative access prices follows on from the sections covering pricing principles. We have also revised the table numbering so they are numbered sequentially, rather than the current numbering system based on where the table is found in the document.

Question 5: Do you have any comments on the proposed changes to the text and structure in the amended guidance document?