

NORTHUMBRIAN WATER'S RESPONSE TO:

**OFWAT'S FUTURE STRATEGY FOR CUSTOMER CHARGES FOR WATER AND
SEWERAGE SERVICES: A CONSULTATION**

1.1 INTRODUCTION

We welcome Ofwat's consultation on the future strategy for customer charges and the opportunity to comment on a number of issues.

The water sector faces some significant challenges and that there is increasing pressure to use tariffs to satisfy a number of different agendas. Reconciling these will not be easy. Whilst this consultation moves some way towards providing a framework for future tariffs there are number of areas we would like to highlight:

- No single tariff is going to deliver on all the charging principles, competition considerations and innovation. It is inevitable that some prioritisation between the charging principles will be required;
- Innovative tariffs require not just smarter meters but also the development of billing systems and internal processes. Smarter meters will also change any cost benefit analyses. This will influence the timescales for introducing new tariffs;
- With the potential extension of competition to all non-household customers it is important to consider consistency of charging principles between households and non-households.

This response is structured in the same format as the consultation document. First we address the proposed charging principles and then we respond to each of the policies in turn.

1.2 CHARGING PRINCIPLES

Ofwat's consultation states that there are four principles which will guide its future approach to charging proposals. These principles are important considerations for any company, however they are very difficult to implement concurrently. For example, 'fair and equitable', which is interpreted as 'broadly cost-reflective', is difficult to reconcile with providing capped tariffs for certain groups of customers, such as vulnerable groups, whilst also providing incentives to customers, which may require strong price signals.

In Figure 1 we have shown an illustration of how we believe different tariffs may deliver on each of the charging principles. While the precise position of each tariff may be open to debate we believe this helps illustrates the point. For example, RV based charges are transparent but deliver little incentive, and if it is accepted that low RV has a relation to low income, they deliver more on affordability than they do on being fair and equitable.

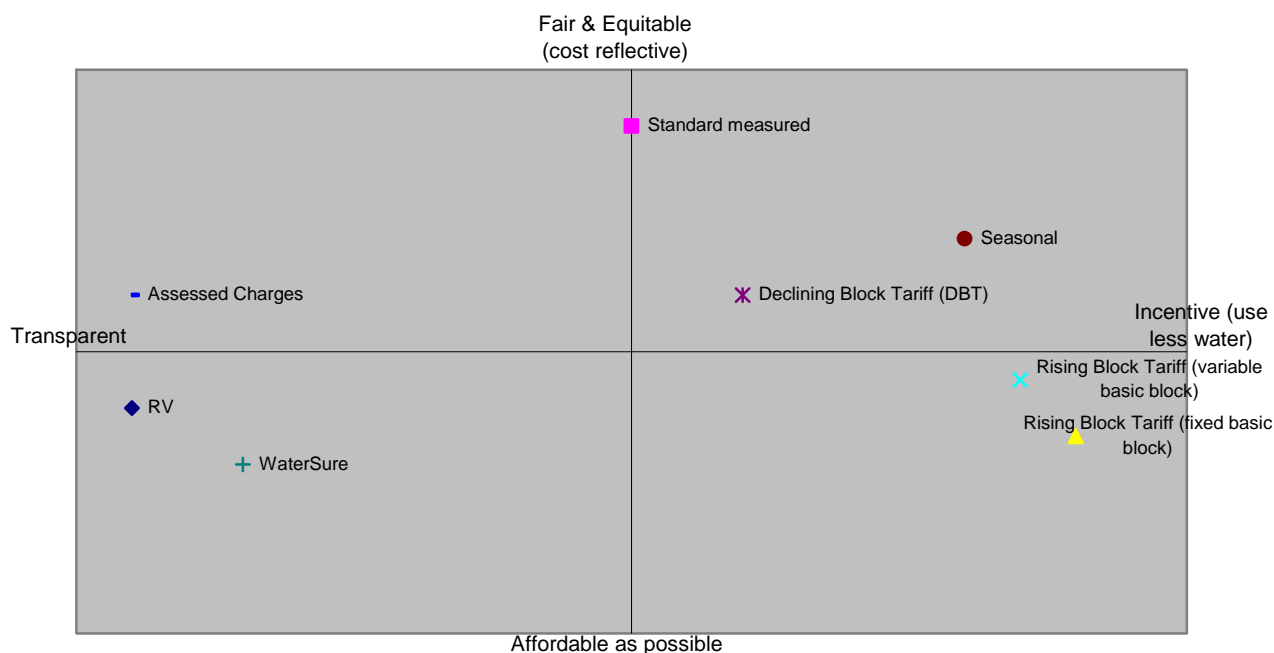


Figure 1 – Charging Principle weightings for different tariffs

Innovative tariffs may be stronger on incentivisation than existing tariffs but more complicated thus making them less transparent.

While the charging principles are clear, the consultation makes no attempt to indicate whether priority should be given to any one principle over another. No individual tariff can deliver wholly on all four of the charging principles, in reality each will deliver a different combination of benefits. The appropriate balance may vary for different companies reflecting their local circumstances and customer base.

There may be some tensions between structuring tariffs to promote and enable competition and structuring tariffs to incentivise customers. For example, retail competition may entail customer related costs being split from other costs. The customer related cost is likely to be a fixed cost, and may be larger than current metered standing charges. The more costs that are recovered under a fixed charge the less cost is recovered under a volume charge, which reduces the incentive on customers to manage their demand.

It is important to recognise that new tariffs designed to meet any of the charging principles will always create losers as well as gainers. It is not realistic to seek to introduce new tariffs on the basis that no customer loses. The case for new tariffs rests on the assessed improvements to charging principles and benefits to those who gain outweighing the impact on those customers who are worse off.

1.3 POLICIES AND RESPONSES TO SPECIFIC QUESTIONS

The following section contains our responses to the each of the paragraph heading contained under section 3 of the consultation document

1.3.1 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?

We believe that paying for water using a metered tariff is the fairest way of charging. If the ultimate goal is universal metering it is not appropriate to incur the cost, disruption, and inevitable incidence effects, resulting from a move to a different unmetered charge which would bring at best limited improvement to the charging principles. We feel that if a customer is unhappy with being charged by RV he has the choice to opt for a meter. Therefore we support 'no change' to the current RV charging system.

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

RV is a simple clearly defined and low cost method of charging. It has been accepted by customers for many years and results in very few complaints.

RV based charging may become unsustainable if a significant number of customers begin to complain about the system or challenge their RV. We are seeing a small increase in the number of customers complaining when neighbours extend their properties and are not charged any more.

When the level of meter penetration approaches universal metering an alternative must be found as unmeterable properties cannot not be left on RV charging for ever. We consider the current solution for unmeterable properties, the Assessed Charge, to a reasonable alternative tariff.

It would seem reasonable that once a certain level of meter penetration has been achieved all remaining unmeasured properties are moved onto the Assessed Charge, possibly on change of occupancy, or maybe wholesale. Some companies may face this situation in the next 5 to 10 years.

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

The RV modifier is the unmetered standing charge. Adjusting the level of the standing charge will slightly modify the group of customers who are incentivised to opt for a meter. However, the incentive to opt is dependent both upon the actual volume consumption of a customer and their RV. The requirement to meet the differential calculations introduces a process for the progressive management of the customers who find it beneficial to opt. We believe that the unmeasured fixed charge should be consistent with how the measured standing charge is derived and with the principles of transparency and cost reflectivity. Companies should be allowed to modify their unmeasured fixed charge to reflect these principles.

1.3.2 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 have already stated that we believe that metering is the fairest way to charge and the best replacement for RV based charging. Given this, and the role of metering in relation to demand management, the ultimate target of universal metering for all companies should be considered as a given. The key issue is the speed of movement from today's meter penetration to 'universal' metering. The appropriate timescale may vary, and should be allowed to vary, significantly between regions, particularly between water scarce and water rich regions.

A robust cost benefit assessment may determine a different rate of metering if smart meters are included in the assessment as opposed to standard meters.

The economic case for smart meters may be stronger in water scarce areas where the importance of price signals that incentivise reduced consumption is heightened. In a water rich area, such as the North East, the case for metering is more about fairness rather than water conservation. It would be more difficult to justify the higher cost of smart metering in these circumstances.

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?

It would be helpful to have a common understanding of what "universal metering" means. It is generally agreed it is unlikely to be 100% of properties. However estimates appear vary from 75% to 95%.

The most significant factor in deciding when a property is "unmeterable" is the cost required to install a meter; to increase meter penetration when approaching "universal metering" a higher cost per property could be considered. A key consideration is the proportion of customers living in properties such as blocks of flats or converted premises with shared supplies which are difficult and expensive to meter. Each company will achieve universal metering at a different meter penetration, due to the different characteristics of the properties in their supply area.

1.3.3 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?

There are three elements to the charge for any customer; customer related costs, fixed operating costs and variable operating costs. Tariffs can be generated by

combining these elements in numerous ways each of which will deliver a slightly different incentive to the customer.

It should be noted that the differential target is **not** the metered standing charge, even though the two numbers may be similar.

It is important to establish whether the metered standing charge is intended to be reflective of customer related costs, all fixed costs or some other combination. The metered standing charge should 'recover **no more** than the customer-related costs for the unmetered service, plus the additional fixed costs associated with providing a metered service.'¹ Historically metered standing charges have been kept lower than this to ensure that volume charges remain high enough to maintain an incentive for customers to reduce volume consumption to reduce bills.

The consultation document states that metered standing charges could be constructed to reflect customer related costs in order to promote competition. Clearly metered standing charges could be constructed to reflect customer related costs.

There is the risk that customer related costs are higher than current standing charges. If the proportion of costs recovered through metered standing charges increases this will naturally reduce the proportion of bills based on volume charges and hence reduce the incentive to reduce consumption to reduce bills and therefore the result could be tariffs with reduced effectiveness in delivering the charging principles set out in section 2 of the consultation.

The relationship between household and non-household tariffs needs to be considered. Consistency is particularly important for smaller non-households who tend to have similar consumption to households.

The possible introduction of Rising Block Tariffs for households may appear to sit uneasily with the Large User Tariffs for non-households where unit charges decline at higher consumption levels. In reality this may be justified since large industrial users will typically not use the local distribution system and therefore should not contribute to its costs. Nevertheless, customers are unlikely to understand the economics and may consider this contrast looks unfair. This issue requires careful communication.

1.3.4 Cost Reflectivity

The consultation paper states that prices should be publicly linked to underlying costs. This relates to the transparency charging principle. However, if tariffs are to deliver on the other charging principles some cost-reflectivity may have to be sacrificed.

A clearer definition of 'cost-reflective' would be useful. Over an entire basket of customers tariffs will be cost reflective as they will recover the costs associated with this group of customers. But at an individual customer level 'cost-reflective' can be interpreted in a number of ways:

¹ Ofwat Water and Sewerage Charges 2007-08 report, p.34

'pure cost-reflective' – each customer pays a bill directly proportional to the costs incurred by this customer. At the extreme this would require regional deaveraging of costs (may imply a customer related cost, a fixed cost and smaller variable cost)

'cost-proportional' – each customer pays an amount that is proportional of their burden on the system compared to other customers (may imply all charges are based wholly on a volume based cost)

'appropriate price signal' – higher users of water will pay relatively more for water than lower users (some volume charges are higher than others which may reflect marginal cost of supply).

Each of these options can be said to be 'cost-reflective' in a different way, but they have very different implications for charges. The choice of method will depend on which of the charging principles is given the greatest weight. If the definition of 'cost-reflectivity' is not further refined companies should be allowed to make their own decisions on which charging principles they wish to prioritise and this will determine how they interpret 'cost-reflectivity'.

1.3.5 Tariff Trials

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?

Tariffs can provide signals to customers to change their behaviour but cannot guarantee a particular outcome. Tariffs offer one tool among many to incentivise water efficiency and need to be viewed as part of a wider package of measures.

The distinction between tariff trials and metering technology trials is not always clear. The two are closely related but meter technology provides a capability and does not dictate tariff choice.

We are currently reviewing the scope for different metering technology and tariffs across the company. It is clear that the circumstances vary significantly between our North East, Essex and Suffolk supply areas.

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?

To set up and run a successful tariff trial all parties must be very clear and agree on the objective of the trial. As previously stated it is very easy to confuse trialling an innovative tariff with testing metering technology or with water efficiency targets or reducing debts.

A trial should be to test an expected result, not simply to see what happens if an innovative tariff is offered. An effective trial may require tariffs to be trialled as one element in a wider package of measures.

Current billing systems and customer services may not be designed to support innovative tariffs and the cost of adapting these to support a tariff trial should not be underestimated.

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

Sharing of results in a similar way to the National Metering Trials in 1990's would be beneficial. There may be a role for UKWIR to coordinate the sharing of research results.

1.3.6 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?

Innovative tariffs are not an end in themselves and the case for new tariffs needs to be made in relation to the objective they are intended to promote. If that objective is to promote water efficiency then the role of optional tariffs is likely to be limited.

Decisions on innovative tariffs and the introduction of smart meters to facilitate them need to be taken in a cost benefit framework. Innovation in itself (i.e. change for changes sake) is not necessarily a positive. The innovation must have a specific purpose and the cost benefit analysis needs to assess the effectiveness of innovative tariffs in achieving the desired objective and compare the value with the cost.

The objectives for innovative tariffs will vary depending upon local circumstances. For instance where peak daily demands are a significant cost driver tariffs can be designed to address this issue. But in other areas seasonal or annual average demand may be the main cost driver and in this case different tariffs may be appropriate. We do not believe that a one size fits all approach can work when the underlying economics of the supply demand balance vary so much across the country.

Introducing innovative tariffs which encourage customers to reduce their bills by reducing their water usage introduces the risk that all bills have to increase over time to compensate for the lost revenue. This risk can be more easily managed with a compulsory tariff than an optional tariff and will involve a continual reapportionment of costs to maintain a fair and equitable level of charging.

There is a tension between setting tariffs with a strong price signal and offering widespread protection, as the protection mechanism will reduce the strength of the price signal. Getting this balance right is difficult.

A tariff with a strong incentive to reduce bills by reducing water use would introduce revenue risk as it would be very difficult to predict the impact of the tariff on demand. Although the revenue correction mechanism partly deals with this, the increased risk needs to be taken into consideration.

To achieve a strong incentive for customers to reduce their water usage the price signals delivered may need to be significant and could entail tariff increases that customers consider to be unacceptable. For this reason it is essential that actions are taken to increase public awareness of the value of water rather than relying on tariffs alone.

The price signal passed to customers is a combination of both the water and sewerage bill and applying prices signals to both services means that the price differential applied can be smaller than if the signals are passed only through the water tariffs. Innovative tariffs for water should also as a general rule be applied to sewerage charges.

We would like to point out that referring to the basic block in a Rising Block Tariff as 'free' is potentially misleading as the block of water is not 'free' but is charged at a fixed rate.

The introduction of innovative tariffs will potentially raise the issue of discrimination between customers, for example if some customers are charged on one tariff and others on another. Further guidance on how Ofwat interprets the requirements of Condition E in this respect would be helpful.

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?

In theory, any tariff could be introduced on an optional basis. However, if the options are transparent customers will always choose the tariff most financially beneficial to them. This will not be the tariff which meets the charging objective targeted.

In practice, there seems limited potential for optional tariffs in the water industry. It is very difficult to offer a differentiated quality or customer service to different customers. Interruptible tariffs for large users are a possibility, however we believe that where customers are interested in this tariff companies have already introduced the option.

For tariffs to be acceptable to customer they need to be easy to understand. Providing many tariff options also reduces this transparency and increases the cost to administer as well as the potential for mistakes to be made. The potential benefits would need to be sufficient to offset these complications.

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

All tariffs relating to the standard water and wastewater service within the appointed business will need to be regulated whether these are optional or not. To ensure that customers not on the optional tariffs are protected the optional tariffs would need to be understood, assessed and monitored.

1.3.7 Affordability and Social Issues

Northumbrian Water believes that social policy is a matter for Ministers and that government should ensure that an adequate social security framework is put in place which pays due regard to the cost of water bills.

We feel that Ofwat's consultation document is contradictory on this matter as it states that affordability is a government issue and then goes on to states that companies will be required to introduce social tariffs.

It is important to distinguish between social tariffs and affordability schemes. A social tariff is where customers are charged a lower tariff, subsidised by other customers, because they qualify for special requirements, such as WaterSure. Affordability schemes encompass all kinds of processes put in place to help customers avoid, manage or recover from debt, for example the South West Affordability study scheme.

Recent Consumer Council for Water research has indicated that there is limited support among customers to extend subsidies for social tariffs and therefore Northumbrian Water does not intend to introduce such tariffs. On the other hand the benefits of reducing customers in debt accrue to all customers and we would support development of schemes that are proven to reduce debt without costing more to manage than is recovered.

1.3.8 Assessed Charges

We agree that Assessed Charges should be based upon an assessment of consumption but we would be concerned about making such charges too complicated. Added complexity increases the costs of administration and the likelihood of errors, and reduces the transparency of the charge.

1.3.9 Sewerage Charges : Surface Water Drainage

We welcome the proposal to require all sewerage companies to charge for surface water and highway drainage on the basis of surface area. We note this is supported in the Defra strategy document 'Future Water'.

Legislation currently restricts the recovery of Highway Drainage to customer connected either for foul sewerage or surface water, whereas everyone uses the highways. This means that properties either connected for water only, or who have their own water and sewerage supplies do not contribute to Highway Drainage charges and are subsidised by other customers. We would welcome further consideration of this issue.

1.3.10 Customer Choice

Ofwat refers to customer choice a number of times in the consultation document, however it is not clear what is meant by choice.

Customers always have the choice to use less water. Tariffs simply send signals to customer to encourage them in certain directions. We do not believe that it is appropriate to allow a customer to choose the way he pays his bill as he will always choose the tariff that is most financially beneficial to him, and with most existing tariffs that are possible, this will not be the tariff that achieves the objective of offering

the tariff in the first place. There is also limited opportunity for customer choice over levels of service, either for water quality, delivery or customer service. We have discussed these points in section 1.3.6.

We think the scope for optional tariffs to provide customer choice is limited and that if tariffs are to provide customers with a strong signal to change behaviour they will need to be compulsory.

We do not think that extending the use of special agreements is appropriate. It removes customers from the tariff basket and effectively deaverages charges by the back door. There must be a clear, measurable reason why the customer should not be charged on a published tariff.

1.3.11 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)?

Typically non-potable supplies are only available where dedicated infrastructure exists. It is therefore quite wrong to think of non-potable charges as applying to that part of the potable system before potable treatment applies. This circumstance may arise in some cases but would be very much the exception.

Given that non-potable systems are quite distinct from potable systems we believe it is clear that charges should be based upon the specific costs of supplying this water.

Northumbrian Water operates the largest non-potable system in the country, on Teesside which accounts for about 25% of water delivered in the North East (195 Mld). This is a discrete system and non-potable supplies are not available elsewhere. All customers supplied by this non-potable system are charged on the same published tariff which is consistent with geographic averaging. We do not believe that the cost of the separate potable system is a relevant consideration in determining non-potable charges.

1.3.12 Technological innovation

As discussed under section 1.3.5, smart meters are required to deliver most innovative tariffs. This is so that more frequent meter readings can be taken without increasing meter reading costs and to be able to accurately determine when different thresholds of charge should be applied, or to ensure that a reading is taken at a specific time and date. In addition to enabling more complex tariffs smarter meters may offer other benefits by providing customers with additional information on their water consumption.

In future charges may need to reflect the introduction of rainwater harvesting schemes or grey water recycling. This could involve similar arrangements to those for surface water drainage discounts.

1.4 IMPACT ASSESSMENT

The impact assessment in Appendix 2 is a useful summary of the main pros and cons for each type of tariff. It would be useful if the assessment could be developed to be more quantitative.

However, the impact assessment does not address the trade-offs implicit in choice of tariff. The selection of tariff is not something that can be done in the abstract. Choices will vary depending on the circumstances and the customer base to which the tariff is to be applied. It is to be expected that this will entail some regional variation.

1.5 OTHER POINTS

1.5.1 Competition

We believe that tariffs that are reasonably cost reflective both in their structure and overall revenue recovery will tend to signal where there may be opportunities for entry by competitors.

Under the current competition (WSL) regime, it is the discounts quoted against standard tariffs, rather than the tariffs themselves, that are used to send such signals – e.g. larger discounts are offered where entry would allow the deferral of planned investment. While we recognise that the principle underlying the calculation of access prices under WSL is currently under review, we still consider that for common carriage the broad approach of calculating access prices on the basis of discounts to standard tariffs, is correct.

Katy Spackman
Pricing Manager