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Dear Mandy

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

I am writing in response to your consultation "Ofwat's future strategy for customer charges for water and sewerage services". Our views are set out below.

We support the principles and strategic themes set out in the consultation document. We do, however, have some reservations about the *application* of these principles, which are set out below in our response to the questions raised in the consultation.

Unmetered charges

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

There will always be some customers for whom meter installation is not practical. The assessed volume charge is currently available as an alternative for such customers. Although we do not have any immediate plans to replace rateable value (RV) charging with assessed volume charges, as the number of unmetered customers diminishes we believe there will come a point when it is appropriate to replace RV charging with the assessed volume charge.

Our Strategic Direction Statement set out our views on this issue: "For those customers who remain unmetered in the medium term the continuing use of rateable value as a basis for charging is unlikely to be sustainable. By 2035 these values will be 60 years old. For those customers who remain unmetered, we will charge on the basis of an assessed volume of water used, dependent on property type. This is a basis of charge which we already apply to some customers".

We do not think it is absolutely necessary to take a definitive view on this at this stage, nor is it necessary for Ofwat to apply a national view; the approach could vary according to local circumstances.

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

A sustained period of increases in charges tends to focus attention on the basis for charging and could make RV charging unsustainable. The main alternative is an assessed volume charge based on property type. We are considering extending our current assessed volume charge to offer a discount for single occupancy, since water use is likely to be below average in such households.

We do not consider it desirable for water charging to be linked to local government taxation, and Council Tax has no more relationship with water use than RV has. In addition, work by the Institute of Fiscal Studies (commissioned by Ofwat several years ago) and our own analysis for the Severn Trent area have shown large incidence effects if charging were based on Council Tax rather than rateable value. Therefore we do not favour switching to charges based on Council Tax.

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

The paper is not wholly clear on what Ofwat's position is on RV modifiers and seems to suggest that they might promote metering. Since they reduce charges for customers with above-average RVs, who are the most likely group to consider opting for a meter, they are very unlikely to have this overall effect. Their advantage is that they reduce the potential size of changes in bills of customers switching to metering (and therefore help manage the pace and impact of metering), since they improve on average the relationship between unmeasured charges and water use. While they will increase charges for low-RV customers, there is unlikely to be any potential vulnerable groups tariff which would offer lower charges. Therefore the suggestion that, if they are used, tariffs should be developed which protect vulnerable customers, is impractical. Since RV modifiers reduce the incidence effect of metering, and may be a useful approach in making a transition to widespread or universal metering, it is not clear why the paper is opposed to their use.

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

We support the suggestion that a wide view of the benefits of metering should be taken, including the potential energy savings from reduced hot water use. There is a forthcoming UKWIR report on carbon accounting which is likely to suggest that water

companies should only assess carbon impacts for which they are directly responsible. However, we consider that it is the whole economy impact which should be evaluated.

There seems to be a presumption in the paper that a full cost-benefit analysis will support higher rates of metering. However, for some companies the analysis may not support going beyond current policy. As metering increases, there may be a case for extending metering for reasons which are not readily incorporated in a conventional cost-benefit analysis, e.g. for reasons of fairness and promotion of competition.

There seems to be a presumption in the paper that tariff development can have a major impact in protecting vulnerable customers from the effects of metered charging. In practice, however, without investigation of income levels there is limited scope. A tariff with a lower volumetric rate for a block based on winter use can assist in avoiding a high charge for essential use. However, in this country, with, on average, a less pronounced difference between winter and summer use, this may have a more limited impact. In addition, it would require more frequent meter-reading than current practice, which would have to be timed to match the seasonal period.

Metered standing charges

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

Costs of retail activities can be regarded as unrelated to volume and should be included in the standing charge. A significant part of distribution activity, e.g. leakage control, is largely unrelated to volume and it could be argued that these costs should also be included in the standing charge. There is inevitably a trade-off to be made between ensuring cost recovery (which might justify higher standing charges) and providing appropriate pricing signals on the marginal cost of water (which might justify lower standing charges). We believe that, in order to encourage water conservation, all distribution, resources and treatment costs should be included in the volumetric charge. This split should facilitate retail competition as the level of retail costs is then clear. As part of the current accounting separation project, Ofwat should ensure that companies are all taking the same approach to allocation of costs to retail activities.

Cost reflectivity

Tariff trials – gaining the evidence – 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?

We support the development of new tariffs and will continue to evaluate the options. However, it should be recognised that they are likely to have a limited impact on

demand – it is charging on a metered basis which probably has the biggest impact, whatever the tariff structure.

There is some evidence from other countries on alternative tariffs but the relevance may be limited if the summer / winter differential is more pronounced than in this country. In such cases, there is likely to be more scope to use tariffs to manage demand or to set tariffs which have a lower charge for essential use.

There may be some conflict between competition and development of innovative tariffs as companies may not wish to share results. In addition, companies might not wish to invest in more sophisticated meters which may be needed for tariff development. There will need to be some reassurance that the assets will not be stranded in the event that metering is exposed to competition. More sophisticated billing and reading systems will be needed, and in order for the tariffs to be effective a significant number of such meters will need to be installed.

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?

Where the impact of a tariff, or customer reaction, is uncertain, making a tariff optional is likely to be desirable. Making a tariff optional may also avoid adversely affecting vulnerable customers. In terms of annual setting of charges, optional tariffs require a forecast which may lead to significant over or under-stating of income (though this will be less of an issue with the implementation of the revenue correction mechanism).

For most customers, only short-term interruptibility is likely to be an option. This has some benefits in avoiding peak demands on the distribution system but is unlikely to justify large discounts or to have a significant impact on future resource requirements.

Optional tariffs need to be demonstrated to be cost-reflective or other customers will be subsidising the tariff.

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 (i.e. possibly more limited use of service reservoirs, pumping, distribution, etc)?

Non-potable water charges should be set so that the right incentives are in place for potential users in making the choice between potable and non-potable water. In general this would require following the regionally-averaged structure but making

reductions for those water supply functions which are not used, or of which less use is made. There may be cases where a deviation from a regionally-averaged charge could be justified, in order to ensure the most efficient use of water.

Assessment of potential impact of Ofwat policies

In our view the following additional points should be considered in the assessment of costs and benefits (recognising, however, that they will inevitably be difficult to quantify):

- No change to RV basis for charging – a qualitative cost should be included, of having a basis for charges not generally understood by customers.
- Rising block tariffs – may adversely affect large families, whose essential use may fall in the higher block.
- Affordability and social tariffs – inevitably customers not on the social tariff will pay higher bills.

We would be happy to discuss any of these issues further with you.

Yours sincerely

Dr. Tony Ballance
Director, Regulation and Competition