

**Consultation on wholesale and retail charges for 2015-16 and charges scheme rules  
Northumbrian Water response  
4 July 2014**

**Introduction**

We welcome the consultation on charging rules for 2015/16 and interpret the consultation to mean that there is no material change to the charging obligations as previously set out by Ofwat, other than the specific rules about recovery of costs for retail competition from non-household only.

Any comments on the specific questions set out by Ofwat are addressed in our responses below. However we would like to take the opportunity to raise several issues where we feel that more information is required quickly, to facilitate setting charges for 2015/16.

Calculating allowed revenues

Northumbrian Water received its Draft Determination (DD) on 30 May 2014. Allowed revenues have been published in our 30 May DD, however this is provided at high level with no information about how it will be used in implementing annual price controls when setting charges. More detail in the areas listed below is required to ensure that we have enough information to properly comply with our allowed price controls, and that all companies interpret their DD in a consistent manner.

- Application of inflation
  - The tables published in the 30 May DD show allowed revenue for all four price controls in 2012/13 prices.
  - The wholesale price controls will be inflated by RPI, but more detail on how Ofwat expect this to be calculated is needed, to ensure that all companies apply a consistent approach.
  - The 30 May DD states the wholesale allowed revenue for 2015/16 in 2012/13 prices and there is no information about how it will be calculated in outturn for each year. There are several possible ways that the wholesale allowed revenue in outturn could be derived, raising the risk of inconsistent interpretation by different companies, or different interpretation between companies and Ofwat. In particular,
    - Whether the allowed revenue will always be calculated from the fixed revenue stated in the FD or whether it will be calculated from the prior year allowed revenue. Calculating from prior year revenues could be done in several ways, such as in 2012/13 prices, in outturn or from the change in forecast revenues. Clarity on which methodology should be used is important.
    - Whether November or annual average RPIs will be used to derive outturn, and whether a change from a fixed baseline to the outturn year will be used or a change from one year to the next. For example, for 2015/16 charges, will the inflation be from November 2011 to November 2014 RPI, or will it use the change between annual average 2012/13 RPI and (forecast?) 2015/16 annual average RPI?
  - The retail price controls will not be inflated, but it would be useful if any figures to be used in any calculations of allowed revenue for each year are very clearly labelled as the figure to be used in that year, or whether some kind of adjustment is required. (i.e. labelling a figure for 2019/20 as in 2012/13 prices is confusing if it is not to be adjusted by inflation).

- Calculation of allowed revenue for household retail
  - The DD provided some ACTS figures and a total household retail allowed revenue. We think we have been able to replicate the household retail allowed revenue, but this is not certain enough for compliance with the price control.
  - As the household retail allowed revenue will actually vary year on year as our forecast number of properties change, a clear, specific formula is required that ensures that all companies are calculating their allowed household retail revenue on a consistent basis. This becomes more important to ensure that any ACTS adjustments are treated correctly and equivalently between different companies.

It seems appropriate that this information is provided alongside with the template to be provided in August 2014 for demonstrating compliance with price controls. Waiting until the Final Determination in December 2014 is too late as it leaves no time for companies to check that they understand the approach before charges for 2015/16 need to be fixed.

We believe that the precise methodology for calculating allowed revenues for each year should form part of the FD and that it needs to be explicitly described in a way that is generic for all years, 2015/16 to 2019/20. It is not adequate to provide an implicit calculation through a spreadsheet.

#### Wholesale charges

The draft charging rules state the retail costs for competition should only be recovered from non-households. These costs are all being put into the wholesale price control and this therefore infers that separate household and non-household wholesale charges are required. Wholesale charges will not be relevant for households as they will not be part of the retail market. Discussion on the implications of this and what should be published for the market and customers, distinct from the information relating to compliance with price controls would be helpful.

Appendix 4 discusses wholesale charges, but does not mention Operating Licence Condition E. There will be a large number of constraints which need to be met when setting wholesale charges, and at some point it is realistic to expect that not every requirement can be met at once, and that some form of trade off will be required. We would welcome acknowledgement that such trade offs will be required, and not all objectives may be achieved to maintain compliance with obligations where required. Where Ofwat states that "*companies may wish to consider how they can use their wholesale charges to help manage the transition to new charges*" (p.25), it would be useful that the final guidance specifies that where companies have made such a trade off, they will not be penalised once compliance is published in the Risk and Compliance Statement (RCS) at the end of the charging year.

#### Publishing charges schemes

Section A1.2 of the consultation mentions charges schemes, however it provides no information on what should be included in a household charges scheme compared to a non-household charges scheme, nor in a wholesale versus and end user charges scheme. It is not clear what level of detail is required, or whether there is a particular format in which the charges schemes should be published. While we understand that this is probably for companies to determine, it would be useful if some kind of minimum expectation is identified.

In addition, wholesale charges schemes are completely new, and retailers will want to be able to easily compare those of different undertakers. This raises the question of whether a more standardised wholesale charges scheme structure may be appropriate. In fact, because the Market Operator will be managing the wholesale billing structure, such as payment terms, will a wholesale

charges scheme be necessary or would the completion of the “wholesale schedule” as set out in Appendix 8 on the consultation, be considered enough?

### Special agreements

In the 27 June PR14 non-household price control submission, special agreements were required to be considered as a separate category of property. We believe that further consideration of how the special agreement revenues fit with the price controls for 2015/16, in particular how the information will be included in the compliance spreadsheet to be issued in August.

## **Response to Questions**

***Q1 Do you agree with the proposed approach to the development of charging arrangements in the 2015-20 period? If not, please explain and provide evidence for your view.***

The four future areas for development of charges defined in the consultation are:

- better understanding of costing within value chain;
- future access pricing for incumbent networks;
- charges for contestable services (non-household retail);
- assessing the different options for charging structures to help send effective pricing signals.

All these subject areas have a significant focus on charges that affect the competitive market, and it is not clear how this interacts with the part of the market that will not be competitive, i.e. households.

We currently have no significant comments to make on the areas for development except for two generic points:

- Timing of any changes needs to be planned well in advance of any implementation.
  - The late definitions of the default tariffs and the implementation of new price controls are causing a lot of difficulty at the moment. We would hope to see lessons identified from this process such that adequate planning time is allowed to incorporate all the required modelling, impact assessment and system development time that is required to change charging structures. It should be noted that we believe that a year’s notice is required if any major changes such as harmonisation of wholesale tariffs is required;
- The objectives and benefits of any changes to charging structures need to be carefully considered and clearly communicated.
  - Many of the areas of development focus on areas relating to the development of competition, which actually may be quite marginal in terms of impact. We would like to see more systematic and clear assessment of objectives, benefits and materiality for any proposals, so that we may have a better understanding and better opportunity to discuss how these objectives may be achieved.
  - We are concerned that household seem to be taking a backseat in a lot of the future direction of charges, and these customers remain the largest group of customers, and revenue. It is not clear how these customers are affected, or benefit from any of the proposed areas of development.
  - We would like to see a clearer distinction between changes that are for the benefit of households and those designed to develop and benefit a future market of some kind.

***Q2 Do you agree with the nominal 5% bill change as a threshold for undertaking impact assessments? If not, please set out an alternative threshold and provide evidence for this view. Should the same threshold apply to all customer types?***

We believe that it is unnecessary to specify a threshold for impact assessments in addition to the bill stability obligation.

Any change to tariff structures will require some form of impact assessment and that, under the bill stability requirement defined by Defra, companies will need to consider how they manage any movement in charges to customers.

Material changes, such as moving to charging for surface water drainage by surface area, may require much larger incidence effects than 5%, and have been successfully introduced by a number of companies in the past.

***Q3 Do you agree with such a threshold being a short-term measure? If so, when should Ofwat remove such a requirement?***

We believe that a threshold is inappropriate in the first place. If a threshold is specified for 2015/16 it should therefore be a short term measure, and be removed after 2015/16.

***Q4 Do you agree with the draft schedule for presenting standardised charging schedule presented in appendix 7? If not, please provide alternative proposals.***

No, the schedule proposed at appendix 7 of the consultation does not cover all the current tariff options charged by companies. For example, surface area bands are not addressed in a manner that covers the 15 bands of the four companies charging in this way. The large user water bands are also not aligned with all the water companies' break points between tariffs.

We believe Ofwat already holds a full schedule of charges, which they used to collect for the annual charging report. This structure would be an appropriate place to start in developing such a schedule, and could be developed further between now and December 2014.

***Q5 Should charges associated with Open Water and market readiness be included as a separate increment to the volumetric charge in the wholesale charging schedule?***

No. The structure of tariffs is designed around the price signals companies need to send their customers to help them make choices about their behaviour. Tariffs are not structured to reflect costs over which customers have no control, or which are unlikely to affect their behaviour.

The costs associated with OpenWater and market readiness are costs that non-household properties will have to pay, and they will have no control over the level of charge as the share of costs across the industry will be defined by a formula that allocates recovery of these costs to each wholesaler and retailer.

Therefore these costs are not appropriate to signal through tariff structures.

There is a distinction between costs that may be interesting to reveal for regulatory purposes for information, and those that may be revealed through tariff structures. Careful thought will be required to ensure that tariffs are not overly complicated or confused by trying to force their structures to do things which are not truly intended to be signalled through charges.

***Q6 Beyond 2015, do you agree that wholesale charges should be published in advance of retail charges? If so, please provide views on how far in advance is appropriate.***

We believe that publishing wholesale charges by the end of January each year would allow wholesalers adequate time to fix and assure their charges after publication of the November RPI and that this gives retailers two months in which to set their charges that will apply from the 1<sup>st</sup> April.

Wholesale charges cannot be fixed until the November RPI is published in the third week in December, and after this date internal assurance must be completed before any wholesale charges could be published. This is usually the week before Christmas, and therefore means the absolute earliest wholesale charge could be published is just before Christmas.

It would be risky to enforce publication of wholesale charges so quickly after publication of the November RPI, and so we believe that they could not be published any earlier than the middle of January. This means there is limited opportunity for publishing wholesale charges any earlier than the 2<sup>nd</sup> February, as required for 2015/16 charges.

One issue that has been raised relating to publication of the new charging year tariffs is that charges need to be defined in time to allow companies to carry out annual billing in February, however we do not think this should be an issue for the non-household retail market, as most non-household properties are measured, and the introduction of the Market Operator will probably move all non-household billing to a monthly basis, which would remove all annual billing for non-household properties.

Therefore requiring publication of wholesale charges by the end of January provides adequate trade off between allowing retailers time to set their charges and for wholesalers to robustly complete their assurance processes after publication of the November RPI.

***Q7 Do you consider that Ofwat should require retail water bills to provide a breakdown of retail and wholesale charges?***

No. Retailers may choose to present their charges in this manner, if the competitive retail market finds this to be useful, but we do not believe it should be required. This is something that the competitive retail market would decide.