Ofwat Consultation on charges scheme rules for 2016-17 and future developments

Business Stream response

Consultation questions

Q1 Do you have any specific views on the draft rules for 2016-17 included in appendix 2? Are there any other rules that you consider should be included?

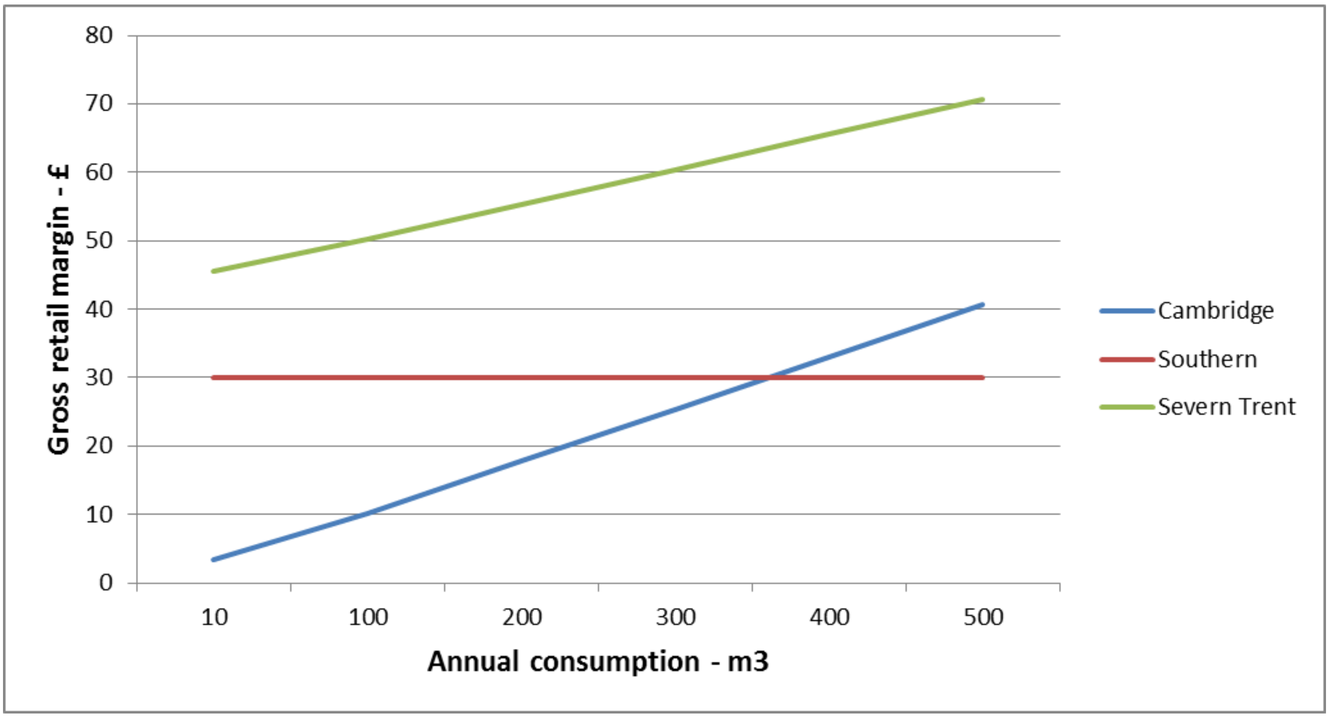
We believe that the rules on non-household charges should include a requirement for wholesale and retail charges to be set in such a way that the resulting retail margins are reflective of the costs of supplying each type of customer and each type of service. Our detailed analysis of the initial set of wholesale and retail charges published for 2015-16 has identified numerous examples of margins that are clearly not cost-reflective, despite the existing obligations. This underlines the need for a much greater level of prescription.

Problems resulting from incorrect margin allocations in this year's charges include:

1. **Incorrect balance of fixed vs variable margin**

The minimum cost of providing a retail supply to a customer involves both fixed and variable costs. Fixed costs include taking meter reads, sending out regular bills, and overheads such as IT. The main variable costs are bad debt and working capital, which increase directly in line with the overall level of charges. It therefore follows that a cost-reflective retail margin must be constructed in a way that means both types of cost are adequately covered.

The charges for 2015-16 contain many examples of retail margins where this is clearly not the case. The chart and table below show the actual water supply margins for smaller customers from 3 water companies:

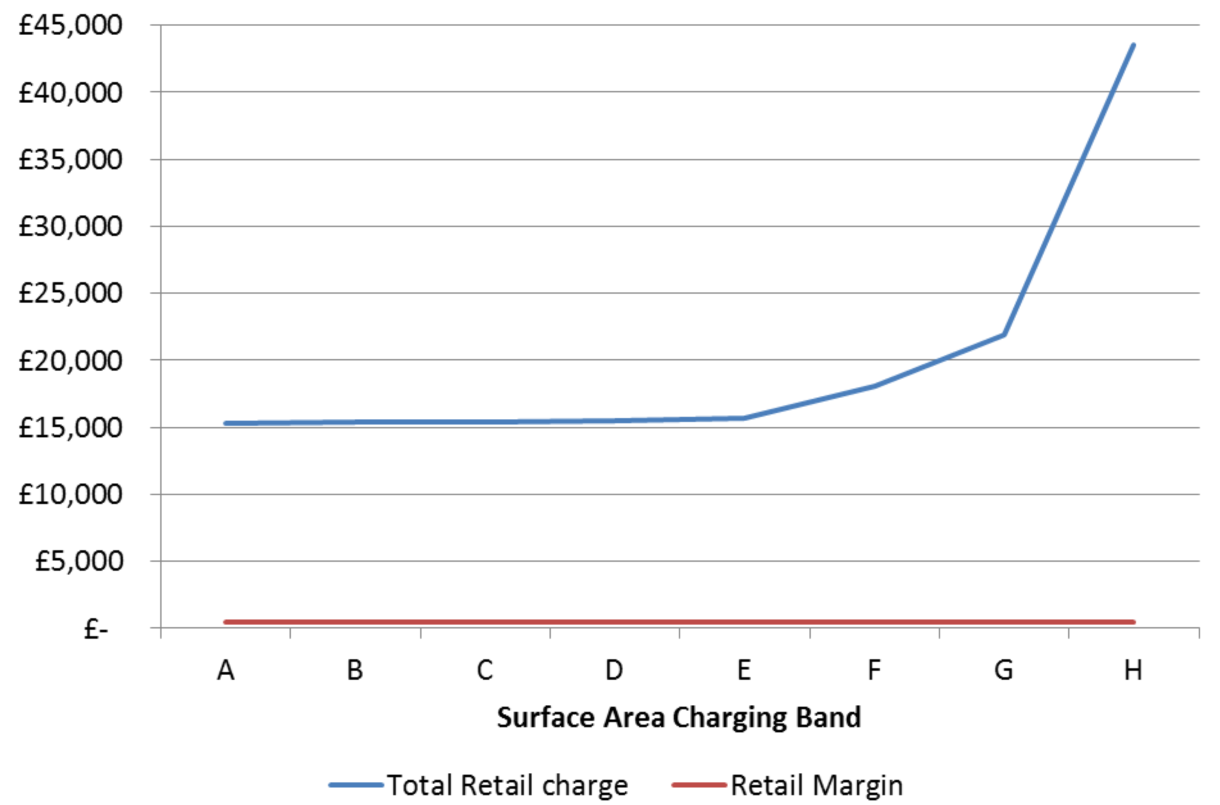


- In the Bristol region, there is a margin on variable charges, but virtually none on fixed ones. This means that the margin on very small consumers is almost zero and would not cover the fixed costs incurred by retailers regardless of consumption. In this case, small customers will not be attractive to competitors.
- The opposite is true in the Southern region, where the margin is 100% fixed and does not increase as the customer's consumption increases. In this case, the margin would not be sufficient to cover costs which increase with volume such as working capital, market operator costs and bad debt risk. Hence small customers are more attractive and larger customers are not.
- The Severn Trent charges include a margin on both fixed and variable charges and hence a more balanced approach to covering the actual costs associated with retail activities.

2. Zero margin services.

There are a number of cases in the 2015/16 charges where companies have failed to allow any retail margin at all on particular services, particularly drainage. The effect of this can be most clearly seen in the case of Yorkshire, which sets its drainage charges on the basis of surface area.

The chart below compares the range of retail charges and retail margins that could apply to a customer using 10,000 m3 of waste water, depending on which surface area charging band applies to them (Yorkshire label these from A to H).



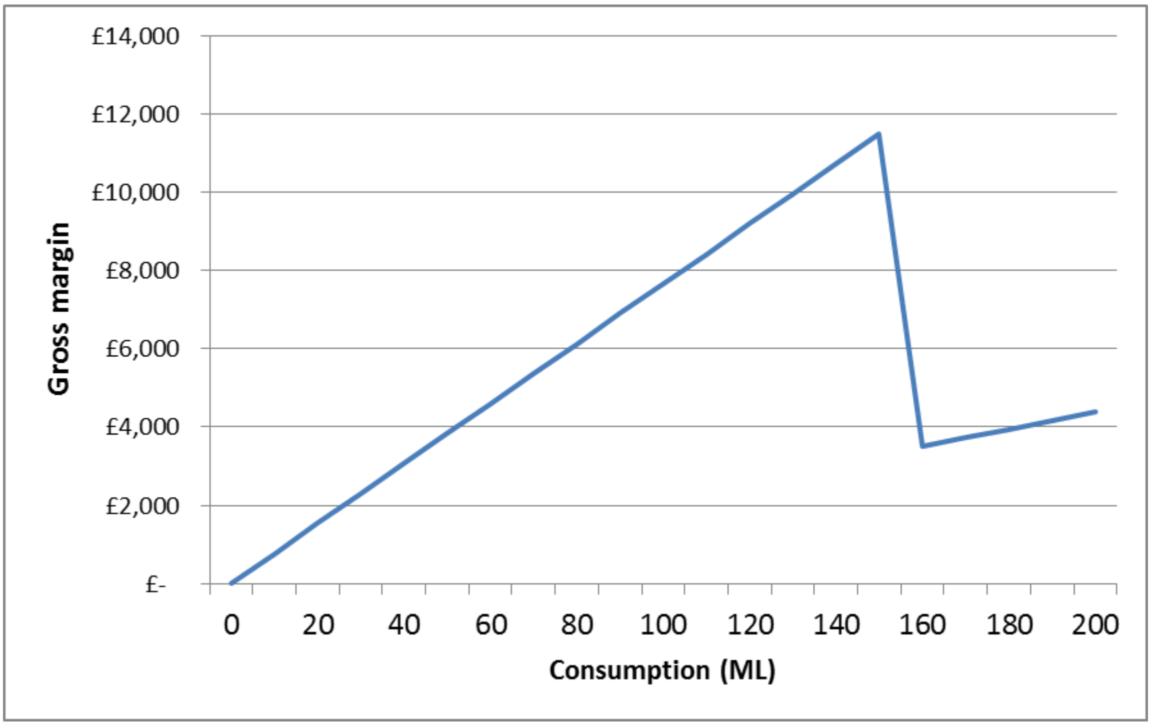
(Waste water & drainage combined)

Band H drainage charges would result in a total retail bill almost 3 times as large as for Band A, but with no accompanying increase in margin to compensate for the higher bad debt and working capital costs. As a result, retailers will generally avoid serving customers with large surface areas in Yorkshire's area.

3. Faulty tariff band transitions

Some tariffs have been set so that there will be an abrupt impact on the retail margin when the customer moves from one tariff band to another. The following is the margin set by Cambridge Water:

	Margin per m3 (on all consumption)	
Standard tariff (up to 150ML)	£	0.0766
Large user tariff (over 150ML)	£	0.0219



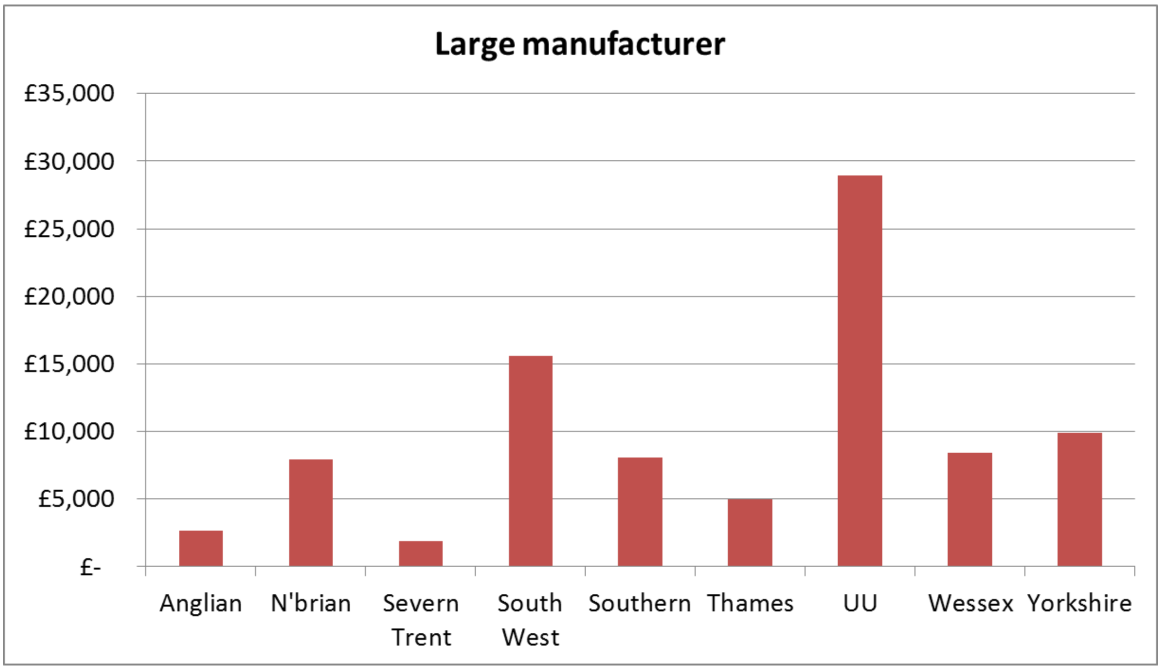
It can be seen that these charges create a "cliff" – as soon as the customer's consumption goes over 150ML, the retailer's margin will drop by over 70%. Clearly, this cannot be reflective of retail costs, and it will create a very strong incentive for retailers to avoid switching any customers either in or close to the Large User category.

4. Excessive variations between regions

We analysed the margins that would be available in each of the 9 English WaSC areas for a large manufacturing company with the following characteristics:

Meter size: 150mm
Water consumption: 175,000m3
Return to sewer: standard
Surface Area: 35,000m2

The chart below shows the size of the retail margin for this customer in each region:



There is a very large variation in the size of these margins, with the largest being more than 15 times the size of the smallest. It is clear from this that there is no common understanding of what the retail costs involved in serving a customer of this type are, and it does not seem possible that such widely varying margins could all be genuinely cost-reflective. The result of this will be to make it impossible for retailers to have a single national strategy; instead, they will have to treat England as 16 individual markets rather than a single unified one, since they will need to significantly vary their service offerings for customers according to the region they are in.

The above examples highlight how the absence of sufficiently explicit guidelines on cost-reflective retail margins up till now has resulted in significant distortions. The examples above demonstrate that this issue represents a serious risk to the market's fundamental success criterion of "all customers being in a position to negotiate better targeted, more efficient and more cost effective services". Therefore, the charging rules should include a specific requirement to ensure that retail margins are genuinely cost reflective.

Q2 How best can site area-based surface water drainage charges be adopted? And what lessons can be learned from how companies have moved to this basis so far?

We have no particular expertise in this area.

Q3 Do you agree with our proposed threshold for 'significant' bill increase? If not, is there evidence for a more suitable threshold? And how this can be assessed for different customer types?

We agree that the proposed threshold seems sensible.

Q4 Do you agree with our current preference of companies publishing their Board's assurance statements?

Yes

Q5 Do you consider that the Board's assurance statement should cover anything else than what we propose above?

We agree that companies should publish their Board's assurance statements, and that these should accompany a statement of any significant changes. However, the current proposals appear to only require Board assurance statements for retail schemes of charges. As the consultation notes, the transparency and cost-reflectivity of wholesale charges will be vitally important to ensure an effective market, and therefore it seems logical to require similar assurance statements on wholesale charging schemes. Given that wholesale charges make up by far the largest part of the final retail charges, it will also be impossible to guarantee that customer charges will be fair and reasonable unless there is assurance on the wholesale portion. If this is not in place, then those appointees that exit the retail market will be able to avoid any duty to provide assurance on their charges for the non-household sector.

Along with the aspects of charging set out in the consultation, we also believe that assurance statements on both retail and wholesale charges should include a specific guarantee that the retail margins on each tariff band and service element are a fair and reasonable allowance for the retail costs involved in providing those services. As we have set out in our answer to Question 1, the retail margins that result from the 2015-16 schemes of charges contain numerous examples of clearly incorrect cost allocations. We think that this is sufficient evidence that there is a need to include a specific guarantee on this point.

Q6 Do you agree with our current preference for companies to submit a statement of significant changes?

Yes.

Q7 Do you have any specific views on the proposals included in chapter 4? Are there any other rules or issues that you consider should be consulted on next year?

As described under Q5, Board assurance statements should be published for wholesale schemes of charges. Beyond this, we are largely in agreement with the proposals set out in chapter 4. In particular, we strongly support the proposal to require companies to publish disaggregated highway and surface water drainage charges, as this will bring clarity to customers and will help to ensure that costs are properly allocated to each service.

Q8 Would it be practicable and/or desirable to include all non-primary charges in the wholesale charges scheme?

We think it is important that wholesale schemes of charges include a comprehensive list of non-primary services, and the charges for each of these. Retailers cannot provide an effective service for their customers if they are unable to price services without constantly referring back to the wholesaler for details of these. In addition, incumbent retailers will be familiar with the range and typical costs of the non-primary services provided by their associate appointee; it is therefore important that new entrants have a ready source of this information so that it does not become a competitive advantage for the incumbent. The suggestion to publish a defined list of non-primary services that all wholesalers would need to include in their charging schemes seems a sensible one.

Q9 Do you have any specific views on the requirement to publish final wholesale charges for non-household customers no later than the first week of January?

Q10 Do you agree with our outline proposal that indicative wholesale charges be published in July and October?

We are happy with the proposed timings of the publication of wholesale charges.