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## Introduction

We welcome the consultation on charging rules and in particular the information about the future of charges.

The receipt of a bill is a key communication point for all customers. Transparency of charges and clarity of messages are crucial to retaining trust and confidence in the sector.

We believe it is necessary in some areas to strike a careful balance between the ideal theoretical charging objectives and a pragmatic option, that can be clearly communicated, is straight forward for customers to understand and easy to implement. The key areas which we believe require further consideration are highlighted below.

### Market opening and non-household retail price control.

A critical part of the successful launch of the non-household retail market in April 2017 is ensuring that charges are clear and robust. There is a lot of work to be carried out over the next year in order to be ready for 'Shadow Operations' in October 2016 and 'Go Live' in April 2017.

Any changes to the structure of charges will need to be applied to the premises information uploaded into the market operator system. The system itself will need to be able to handle all new charging structures. The greater the uncertainty around charging structures for non-households, because there may be new requirements for 2017-18, the higher the risks and amount of work required for testing and 'Go Live'.

There are a lot of areas in chapter 4 where change has already been indicated for 2017-18 (see response to question 7). We need absolute clarity as to what the rules for 2017-18 will be, in detail, and with confidence that they will not change. This will allow us to set the non-household retail price control correctly, to have sufficient time to update any charging information about premises for the upload of data to the Market Operator, and for testing in the new Market Operator environment.

**In our view it is critical that consultation and publication of 2017-18 charging rules is carried out by June 2016. This will ensure information can be incorporated into the non-household retail price control review and so that companies can finalise their charges structures early, without the risk that the charging rules may enforce a change at a later date.**

One option to minimise risk may be to impose a freeze on charging structures for non-households until the 2018-19 charging year.

### Realistic timetable and preparation

There are a number of activities that need to be considered so that a change to charges can be implemented in a robust manner. These include:

- Analysis of the charging options available to meet the new requirements, and consultation with customers to that the best option can be chosen;
- Understand the potential impacts on customers, especially vulnerable customers, and their bills;
- Communicate with customers and other stakeholders such as CCWater and Customer Consultation Groups (CCGs) about the reasons and impacts of any change to charges;

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

## Northumbrian Water Limited Response



- Update internal procedures, training and reporting to embed the new information in the company, which ensures any queries can be managed efficiently and effectively; and
- Develop, test and implement any necessary changes to billing and financial systems needed to bill and report against the new charges.

All these actions take time to carry out, we would emphasise that a reasonable timescale is needed between notifying that a charging rule will change, preparing for that change, and the time at which it is included in the charging rules for a particular year.

We believe that consultation on charging rules in the summer and autumn of the year before the charges rules apply is too late to allow reasonable time to implement any changes. As a preference we believe that charging rules should be issued a year in advance (i.e. 2017-18 charging rules should be issued now). At the very least any proposed changes to the charging rules should be signalled a year in advance to allow for reasonable planning and preparation.

We welcome the way the change to foul, surface water and highway drainage charges is signalled in this consultation as planned for 2017-18, and feel that rule 21 on partial surface water drainage charges should be treated the same way.

### Publication of charges

The annual announcement of water and sewerage charges is a key industry wide communication for customers and the press, one which helps set the tone for relationships between the industry and customers. With the introduction of wholesale charges there are now multiple versions of charges. There is a risk that household customers and the press may pick up on wholesale charges as the next year's charges, and when these will not subsequently be applied on household bills this could cause confusion.

Therefore the impact of multiple publications of charges information needs careful consideration. We feel that there is a trade off between helping retailers set up the non-household retail market by publishing wholesale charges at various points and the messages passed to household customers. We feel that a single formal, and final, publication of charges in February is important to keep messages clear, and that the perception of households needs to be given significant consideration.

### Impact assessments

The new and proposed changes to charging rules for sewerage services are a significant change to the structure of charges. There are three areas included in the consultation: rule 21 requiring partial surface water drainage charges, the proposed new rule for 2017-18 on separate foul, surface water and highway drainage charges, and the discussion on the introduction of site area based surface water drainage charges.

Defra's key charging objectives are set out in chapter 2 of the consultation document. We are unclear how these new sewerage rules have been assessed against the key charging objectives, and what benefit they will deliver for customers.

Customers consistently inform us, especially household customers, that charges are already complicated. The costs of implementing and maintaining enhanced sewerage charges need to be outweighed by any increase in fairness or transparency to customers. There is a real need to balance the theoretical or economically assessed improvements to charges against the practical management, communication, costs and customer perception of the proposed changes.

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The three sewerage changes heavily interact with one another and decisions on one area will affect decisions on another. We are unconvinced there is a clear case for all of the proposed changes to sewerage charges for all classes of customer. For example we strongly disagree with the requirement for separate highway drainage charges, as discussed in our response to question 7.

Development of a statement of the objectives these rules aim to achieve, along with an impact assessment would be helpful to determine the most appropriate approach to dealing with sewerage charges, as a single subject area, before including any new sewerage charging rules. We would be happy to contribute to the discussion and to explore the potential solutions to achieve a fair balance between the theoretical, economic, practical and customer focused aspects of charging.

In developing the charging rules it is unclear what role impact assessments will play. The Defra Charging Guidance to Ofwat indicates that impact assessments are required, and there will inevitably be some assessments carried out by Ofwat and some by companies. We feel more work is required to be clearer on when and who should carry out each impact assessment.

If Ofwat are setting out a charging rule we feel that this should be supported by a statement of objective and an impact assessment. We feel companies would add value if given the opportunity to contribute to this process, and it will ensure everyone understands the new charging objectives, and works towards achieving them. We understand that this is the first year of the new charging rules process, and feel there is still room for further development around how change to charging rules will be managed.

#### Company ownership of charges and industry coordination

We agree that individual companies need to take ownership of their charges. However industrywide coordination of messaging in certain areas, such as the introduction of site area based charges, may be beneficial and there may be a role for Ofwat and CCWater to play in this. We would support efforts to help share best practice where appropriate and facilitate carrying out industry level research so that efforts across companies are not duplicated. This approach would also ensure consistency for customers across companies.

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## Response to 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 rule 21 on partial surface water drainage charges should be treated in the same way as the separate sewerage charges and its introduction be planned during 2016-17. It is very late in the charges setting process to introduce a new requirement and expect a robust analysis and smooth implementation process. Rushing this through would impact preparation time and lead to poorer outcomes for customers and companies.

We believe rule 21 should be considered in the same way as the requirement for separate foul, surface water and highway drainage charges and site area based charging.

Rule 5: Definitions – the common and legal terminology used in charges for the water industry are 'household' and 'non-household'. We feel it would be more appropriate and less confusing, if the definitions in the charging rules used the same terminology as the licence, instead of the term 'domestic'.

*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?*

If Ofwat is planning to require all sewerage companies to charge non-household premises for surface water drainage on a site area based assessment, we believe there are several things that must be considered:

- Any requirement for surface water drainage charges to be based on site area should be limited to non-household charges, as the case for the benefits to household charging is not clear. Any change to the charging rule would need to be clear about which classes of customers should be charged on a site area basis.
- The new requirement will need to be clear about whether all companies must charge exactly the same way (i.e. on a harmonised basis using the same number of bands and areas for each band), or whether companies can use their own methodology, so long as it is based on site area in some format. Companies will only be able to start a realistic analysis once Ofwat has defined exactly what requirements are to be put in place.
- A reasonable and practical timetable for implementation of such a change must be planned and allowed for. Given our positive experience of introducing site area based charging, the length of time required to implement such a change cannot be underestimated. Time is required to measure the site area for all the premises, discuss these areas with customers to confirm they are appropriate, model the new tariff levels, understand the impact on customer bills and then plan for the phasing of charges to the new structure.

We believe that at least two years must be allowed for so that this analysis can be carried in a robust manner. This timeframe is important to plan activities which maintain trust between customers, retailers and the water industry. Such a movement in charges will have a significant impact on some bills so customers must be involved as well as retailers, there must be also clear communications on the process so that they can understand the reasoning behind the change and plan for the impact to their bills.

In addition, the phasing from the old basis of charge to the new basis of charge took three charging years for the NWL migration. In year one, charges were based 67% on the old basis of charge and 33% on the new basis, in year two, charges were based on 33% on the old basis of charge and 67% on the new basis. It was only in year three that charges were 100% based on site area. For two years, two sets of tariff were charged to customers, and this means that the Market Operator systems would need to be capable of handling this.

The success of any move in the basis of charge will be dependent on the quality of analysis, communication with customers and planning. This is largely dependent on time, and we believe this is the most important aspect that must be considered when making a change to a charging structure. Our carefully planned approach and clear customer communication were critical. Companies which adopted a less measured approach to introducing site area charges attracted far greater customer complaints.

If harmonised charging structures are to be introduced, this will require change for the whole industry, including those companies already using site area based charges. We are strongly of the view that the detailed charging structure including choice of bands should be left to individual companies so that they are able to reflect the specific customer base.

We include a more detailed view at Appendix A.

*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?*

The 5% threshold is set as a flat figure with no recognition of either price controls or changes. This raises some issues of proportionality, as set out below.

- If inflation increases, this may cause prices to increase by more than 5%, due to reasons outside their control.
- Price controls are set at different levels for each company. The 5% threshold is more likely to be triggered by companies with a higher price control.

We believe that the true intention of a threshold for impact assessments should be to assess whether bill stability is being considered for all classes of customers within each company.

An alternative approach would be to set the threshold relative to variances from the allowed revenues already set under the price controls. For example, if the threshold is set at +3% above the allowed wholesale price control  $K + RPI$  change (separately for water and sewerage), this applies a proportional requirement for each company. The threshold flexes to take account of changes to price controls and inflation over time and it also limits the requirement to carry out impact assessments that are effectively a duplication of the price review process.

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

We have no comment to make about rule A1 about publication of the Board Assurance Statement.

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

We believe that the content of the Board Assurance Statement should not be predefined and should be able to include any information that the Board wishes to include, so long as the required points are addressed. In some cases caveats may be required, to explain where, for example, there has not been time to implement a new requirement in the short timescale between publication of the charging rules and the new charging year.

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

The consultation states on page 19 that the statement of significant changes "*could help identify possible issues or concerns, and inform us [Ofwat] whether we would see any benefit in engaging with a given company in advance of their charges coming into effect.*"

Three weeks before publication of charges is too late for Ofwat to engage with companies about their charges, and therefore providing a statement of significant changes at this point would be a pointless exercise generating an unnecessary additional regulatory burden.

If Ofwat wish to engage with companies before publication of charges this will need to be carried out in the summer and autumn before the charges come into effect, as this is when company Boards make decisions on such changes. A statement of significant changes would be better provided to Ofwat at this point.

We feel that there is therefore a choice. If Ofwat wish to have an input to company charging decisions before charges are implemented then a realistic time for consultation needs to be allowed, that is completely separate, and well in advance from the process of publishing charges. If Ofwat wishes to act ex-post, then we see no benefit from a statement of significant changes that is separate to the Board Assurance Statement.

We believe that rule A2 should either:

- Change the timing of any statement of significant changes to the summer or autumn of the year before the new charges come into effect. It would then be logical to provide this with any early publication of indicative wholesale charges; or
- Remove the requirement for a statement of significant changes included in the Board Assurance Statement in rule A1.

*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?*

#### General points

We welcome the indication of future direction set out in chapter 4, but note that there is a lot of activity planned for next year. Chapter 4 and the rest of the consultation indicate that there will be new rules for 2017-18 around the following subjects:

- Special agreements
- Wholesale charges rules
- Early publication of indicative wholesale charges
- Non-primary charges

- Site area based charges
- Developer services.

From their inclusion in chapter 4 we infer that none of these items will be included in the final charging rules for 2016-17, but will be included for 2017-18.

This is a significant amount of change, and work, at a time when there will be significant change due to the full opening of the non-household retail market in April 2017, as well as the review of the non-household retail price control in mid 2016.

From October 2016 companies will be in full shadow operation for market opening and this will be a difficult time for companies and their Boards to focus on late changes to charging rules.

We therefore feel that is extremely important that the 2017-18 charging rules consultation takes place by the spring of 2016.

Companies will need to carefully plan their activities next year in relation to charging as this is very important to successful market opening. A key activity will be to identify which tariff each premises is charged and upload this to the Market Operator systems. The more changes to tariff structures required because of the charging rules the greater the risk that the Market Operator system may not be able to cope, or that information is incorrectly identified or that several uploads of information are needed.

Publishing the 2017-18 charging rules any later than spring 2016 would make it very difficult to implement changes at a time when information needs to be fixed to test systems for shadow operations.

#### Separate sewerage charges

We are pleased to see that there will be separate consultation on separate foul, surface water and highway drainage charges.

We strongly disagree with the requirement for separate highway drainage charges. We are not convinced that separate highway drainage charges are meaningful or a fair approach for customers, nor that they deliver increased transparency of the service customers receive. Highway drainage charges cause confusion for customers because they have no influence over the level of highway drainage costs.

A consultation on separate highway drainage charges will provide the opportunity to discuss these issues and consider the benefits and impacts of separate highway drainage charges.

#### Special agreements

We agree that more clarity is required about the treatment of special agreements. It is important that this is clear both for the initial upload of information to the Market Operator systems, but also for the review of the non-household retail price control in July 2016. We therefore re-iterate that consultation on all charging issues needs to be carried out in early 2016 so that all changes can be incorporated into the price control and the data for the new systems.

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

We feel that this requirement needs to be clearer and consideration needs to be given to the following points:

- Companies have both appointed and non-appointed non-primary charges. In our view the charges schemes should only be required for appointed charges, but companies could include non-appointed charges on a voluntary basis should they wish.
- A standard charge is not appropriate for all activities.

If there are certain non-primary activities that Ofwat feel should be identified in a charges scheme we feel that Ofwat should include this list in the charging rules, and otherwise the choice should be left to companies.

*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?*

We infer from its inclusion in chapter 4, page 23, that the requirement to publish wholesale charges no later than the first week in January will apply from 2017-18 charges, and not for 2016-17 charges.

We do not believe that companies should be required to publish charges schemes earlier than the first working day in February.

The November Retail Prices Index (RPI) is published on the 3rd Tuesday of December, and after this date it is necessary to finalise the charges modelling, convene a final sign off with the Board and update the published charges schemes with the final charges. The fact that this occurs over the Christmas and New Year period has a constraining factor on people's availability and will affect the time required to finalise the sign off process.

If indicative wholesale charges are to be published in October then we do not see the benefit in publishing wholesale charges in January rather than early February.

We would also note that publication of wholesale charges in mid January would include household wholesale charges that will not be the actual charges shown on customer bills. The risk of having two separate publications within a short space of time needs to be considered. We feel that the risk that household customers and the press pick up incorrect wholesale household charges, and the impact this would have on trust and reputation across the industry outweighs any benefit from publishing wholesale charges two or three weeks earlier than other charges.

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

Every publication of a version of charges will require some form of Board sign off and assurance. The more submissions that are required, the greater the regulatory burden for companies to manage their publication of charges. We would like to better understand the benefits of these additional charges publications against the increased regulatory burden.

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We believe that if indicative charges are to be published in advance, then one single publication should be adequate. The October timetable would be more reasonable for this, and should result in less movement to charges than if indicative wholesale charges were published in July. This would also be an appropriate time to provide a statement of significant changes to charges, as discussed in our response to question 6.

In principle, indicative charges could be published in advance, but we disagree with the requirement, at any time, to publish a fixed set of charges that can only change for the update of the November RPI. Customer demand is constantly changing, and new customers may come on line, or existing customers may close at any time. Freezing this data in September, which would be required to achieve an October publication, means that two months of additional data will be ignored. Even if such a restrictive requirement for publication in October was put in place, we believe that companies should still be able to update their wholesale charges if new information that would have a material impact on modelling becomes available between October and December.

The consultation is unclear about whether the two advance publications will be required in 2016 for 2017-18 charges to facilitate the launch of the full non-household retail market, or whether this will be an annual requirement. We would like further clarity on this point.

We feel that publication of indicative wholesale charges should be limited to non-household wholesale charges only. We feel that there is an unacceptable risk that households or the press will pick up on these charges and use them as a baseline expectation for household charges. As previously stated, the confusion around this happening could have a reputational impact on the industry and undermine trust between the industry and household customers.

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**Appendix A Northumbrian Water Limited Experience of introducing surface areas based charges for surface water drainage for non-households**

Northumbrian Water has been charging for surface water drainage entirely on a site area basis since 2008-09. This process began in 2003 and took three years to move through the development of the charging structure and three years to phase customer's charges from the old basis of charge to the new basis. Careful planning, preparation and customer engagement were critical factors in our successful introduction of site area based charging for surface water drainage.

If it is Ofwat's intention that all companies charge on a site area basis for surface water, using our experience from implementing site area based charges for surface water drainage, the key factors we feel should be considered are set out below.

1. Allow a realistic timescale for moving to the new basis of charges, and state it in any new charging rule.

Determining a realistic timescale for implementation of site area based charges would need to take into account the following points:

- Before any charging can be carried out on a site area basis companies must first:
  - Engage with CCWater and Ofwat on the process to be followed and the incidence effects and phasing plans as this information becomes available;
  - Set up of the project teams, and governance processes to oversee implementation, identification of resources available to work on the project;
  - Assess the site area for each of their premises, a significant proportion of which will require a visit to site;
  - Communicate with customers and involve them in determining the surface area measurement;
  - Consult with customers on whether a concession is required (as set out in the Defra guidance on SWD concessions);
  - Model the level of new charges, which can't be done until a reasonable amount of information is available about what surface area each premises has;
  - Analyse the incidence effects for each individual customer and provide tailored communication to each customer so that they understand what is happening to their bill;
  - Phase charges to manage incidence effects for individual customers.
- In our view, and on an optimistic basis, at least two years is required to carry out these activities. This brings us to 2018-19 as the earliest possible charging year site area could be used on bills.
- From the point at which site area charging begins, at least three years of phasing may be required to manage incidence effects.
  - We phased our movement in charges over three years, where in year one charges were based on 33% site area and 67% on the old basis, in year two charges were based 67% in site area and 33% on the old basis and in year three charges were based 100% on site area.
  - Therefore if charging on site area began in 2018-19 then two types of charge would need to be billed during 2018-19 and 2019-20 and the first full year of charging solely on site area based charges would be 2020-21.

- Depending on the levels of incidence effects, some companies may require a longer phasing period.
  - During any phasing period two types of charge structure will need to be chargeable on non-household wholesale bills and the Market Operator system and retailers would need to be able to cope with billing these dual structures.
    - We believe it would be optimistic to reach the point of being able to charge using site area for 2018-19, as this is only two and a half years from now.
2. Consider how the change will be communicated with customers and how they will be engaged in the process.

To minimise complaints and disruption it is important that the customer, as well as the retailer, understands the change and what it means for them. In particular:

- customers need to be given the opportunity to be involved in setting their surface area measurement; and
  - It must be clear that the exercise is revenue neutral for the company, and that the programme is about fairness and giving appropriate price signals.
3. Before requiring companies to charge on a site area basis, companies should be given an opportunity to propose alternative charging mechanisms, as there may be reasonable alternatives.
4. If all companies must charge on a site area basis then Ofwat should consider whether the full structure of the charge should be harmonised across the industry, including for companies who already charge based on site area. This harmonisation could consider some or all of the following:
- That all companies use the same number of bands, and the same areas for each band;
  - That all companies use the same definition of measured site area;
  - That all companies use the same methodology to apply or apportion site areas for properties inside the same building; and
  - That all companies used the same mechanism for reviewing surface area over the longer term (for maintenance of accurate surface area measurements).

It is our view that if there is a requirement for all companies to charge on a site area basis it is logical to also fully harmonise non-household wholesale surface water drainage charging structures across the industry to facilitate the non-household retail market.

5. Any harmonised basis of site area charging should be developed at an industry level, with involvement of all 10 sewerage companies, Ofwat and CCWater to work in the most efficient way as an industry and to minimise duplication of effort between all parties.
6. Any charging rule specifying site area based charges should be limited to surface water drainage charges. In our opinion, highway drainage charges should be treated as a completely separate subject, which companies can choose to recover in any manner they deem appropriate. If Ofwat wishes to require harmonised highway drainage charges as well, this should be developed in the same way as site area based charges, but as a separate project.
7. Any harmonised charging approach will need to consider how partial surface water drainage charges (as required by rule 21) will function alongside site area based charges.

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8. Clear rules must be set out, that all parties can work to. The rules need to be specified before the changes to charges are implemented and need to include:
- When a premises is connected or not for surface water drainage. For example is a premises drains to a third party SuDS, which in turn is connected to the public sewer, is the premises or the SuDS charged and which area measured?
  - How is a surface area measured?
  - How do we make sure that a surface area measurement remains valid over the long term, for example in 5 or 10 years time?
9. Introducing a new basis of charge such as site area will have material cost implications, for example site visits, changing of data in systems and multiple communications requirements. The cost cannot be underestimated and would be a new requirement to be absorbed under the current price controls. It may be appropriate for Ofwat to consider the implications of this in assessments of performance and efficiency.