

Consultation on charges scheme rules and future developments

Severn Trent Water response

30 September 2015

Summary of our response

We welcome the opportunity to provide feedback on Ofwat's draft charging rules for 2016/17. Our response builds on comments we have made before the start of this formal consultation.

In general we are supportive of the draft charge scheme rules, which are founded on charging principles which Ofwat has developed over a number of years. Given the significant changes taking place within the industry, including market opening in 2017, we are supportive of the evolutionary approach being adopted by Ofwat. There are only two aspects of the proposals where we have significant concerns.

Highway drainage charges

We have raised the proposal to require separate highway drainage charges with Cathryn Ross and Defra. The consultation proposes a "pilot" separation within wholesale charge schemes. While this compromise is preferable to a split in the customer charge scheme, we still believe that Ofwat should consider what benefit will be achieved by taking this step.

Like Ofwat, we think that the revelation of information can be critical to promoting better decision making. For this reason we see the transparency of charges as being a powerful tool to drive behavioural change. However we are concerned that publishing components of charges in which customers have no control - specifically highway drainage¹ - will not lead to better decisions (as the cost is not caused by customers).

In the consultation Ofwat explained that it supported publication of these charges on the basis that *"customers and retailers can benefit from transparency about these components. Transparency would allow customers to respond more directly to price signals embedded in the charge. This can have a positive impact on the environment. Transparency would also allow retailers to have an informed discussion with customers on ways to reduce their bills"*. However this ignores the fact that highway drainage costs are not like surface water costs. This is because behaviour cannot influence this cost as it reflects the cost of roads and highways (and those investment decisions).

Since the cost is not driven by customers' property or consumption, there is no correct way to charge for this item. Two approaches have actually been employed in the industry to date – a flat rate and a link to surface area. Adopting either of these approaches at wholesale level would have an impact on customers where there is not already a separate charge. We also note that customers not connected to the sewer system cannot be charged for highway drainage. This also raises issues about how it can be fairly levied.

Before Ofwat introduces a pilot we think it should consider what method ought to be used as this will have real consequences for customer bills.

¹ Section 146 (4) of the Water Industry Act prevents sewerage undertakers from charging a highway authority for the costs associated with draining roads and other common areas

We think that consideration should be given to alternate ways to provide transparency about such costs and have suggested alternative ways in which this might be achieved in our response to question 7.

Early publication of Charging Schemes

While we understand retailers' desire for an early view of wholesale prices, we question whether these proposals will deliver the level of certainty they seek. Fixed price supply contracts are common in energy supply, but retailers pay a premium for reducing their risk in this way.

The early publications envisaged are subject to future changes in volume and RPI. We think these will be of limited value to retailers because they will be based on lower quality information. They may actually be harmful if they constrain our ability to respond to market feedback.

Early publication will, however, generate an additional regulatory burden. As a public company we could not put information into the public domain which had not been fully assured. Given the limited value of the information, we are not sure that this is justified.

We are concerned by the suggestion that changes between October and January should be limited to the difference in RPI alone. To set charges we need to balance multiple constraints, and are also subject to financial penalties if we do not forecast revenue accurately. Given this requirement, it does not appear reasonable that we should be prevented from using newer information when setting our charges.

If you would like to discuss anything in this response further, please do not hesitate to contact myself or a member of my team.

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1. 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?

In the sub sections below we provide some drafting suggestions for Ofwat's rules.

Rule 15 – large water users

This rule is currently worded as if this is an exhaustive list of reasons for differences in charge. We suggest it is amended to read “such as...”. There are two reasons for this:

Firstly, the rule is currently limited to differences arising from “network” (wholesale) costs alone. There are other potential reasons for differences in charge involving the retail element of the bill which are not covered by the rule. Although non-default tariffs are not subject to regulation, default tariffs and household tariffs ought to be justified by differences in cost – remembering that the bands are based on average revenue per customer and that there will be variation within them.

Secondly, the definition of “network” may change over time with the introduction of upstream separation or competition.

Rule 17 – sewerage charges

A possible interpretation of this rule could suggest that there are differences between household and non-household foul water charges based on load.

Historically we have not differentiated bills in this way because small non-households are very similar to household customers. However we recognise that there are grounds for differentiating between large sewerage customers and other classes of customer. The reasons for sewerage discounts are similar to the discounts offered to large water users – the position on the network, their use of assets, and load.

We recommend that the wording is changed to “must take into account the different pollutant loads, where they exist, for household foul sewage, non-household foul sewage, trade effluent, surface water draining from premises and surface water draining from highways.”

Open water charges

Government has stated that households must not pay for the costs of the market operator and Ofwat's own guidance made clear that these costs must be ring-fenced and included within non-household wholesale charges (May 2014 consultation on charges scheme rules). This difference is not picked up in either rule 15 or 17; this is another reason why we think the rules should avoid the suggestion that they include an exhaustive list of the cost items that can justify a difference in charge.

2. 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 are very much supportive of Ofwat's principle in this area. This is why we were the first company to bring forward site area charges for surface water drainage and believe that this is the fairest practical way to charge for this element of the service. It satisfies one of the key principles for charging in that the form of the charge provides an incentive for a positive change in customer behaviour.

Nonetheless, we recognise that there can be significant incidence effects for some customers. Therefore we do not think that the six companies which do not currently use this approach should be obliged to introduce it rapidly. To do otherwise could reduce trust and confidence in the water sector.

In relation to how to adopt site based area charges, we have set out our experience and learnings to support Ofwat:

- We started by introducing site area charges for new non-household customers as there was no existing Rateable Value (RV) on which to charge. This might represent a first step for other companies.
- When we transferred the remainder of our measured customers we recognised that there would be a very significant effect on some community groups. We brought in concessionary schemes straight away – for a number of customers this meant allowing them to retain RV-based charges until there was a significant alteration to the property.
- We allowed measured households to retain RV-based charges until there was a change of occupancy – although we proactively transferred any customers who would be better off onto a property type (site area)-based charge.
- All of the measures we adopted preceded the Government's 2010 guidance on concessionary schemes; we note that DEFRA has signalled a possible review of this document, which may offer companies further scope to offset the incidence effects for some customer groups.

3. 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 are supportive of Ofwat's attempts to define what "significant bill increase" means as this will provide greater certainty for all involved. However we think there are opportunities to make improvements to reflect the:

- Impact of inflation; and
- Difference between percentile and absolute changes for customers on very low bills

In the current low inflation environment a 5% target is workable. However it would be impractical if we return to the levels of inflation seen in the past. For example, in 2011-2013 November RPI was over 4% per year and in the early 1990s it reached over 9%. If inflation is running at over 4% then any customer that does not switch to a meter during the course of the year is likely to require an impact assessment. This would create a significant regulatory burden.

A workable alternative would be to include RPI in the measure – for example 2.5% plus RPI (e.g. 2.5% inflation would give rise to a 5% nominal figure as you suggested). This would prevent excessive regulatory burden whilst also providing customers with a degree of protection.

Finally we think consideration should be given to adopting something alongside a percentile target. This is because a percentile target is not a good measure of significance when it is applied to charges that are already very low. For example, our minimum charge for water is just under £94; an increase of £5 per year on this charge would require an impact assessment but is unlikely to have a significant effect on any household. A simple alternative would be a threshold defined as the greater of 5% of the customer's bill or 5% of the average household bill for the company (or a 2.5% real increase in the average bill when combined with our first proposal).

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

We are supportive of the principle of transparency and are happy in principle to publish the Board statement of assurance. We agree that the Board should provide a statement that it is satisfied that the submission materially complies with our statutory and legal obligations. However, we believe that there should be sufficient flexibility in the wording of the statement to ensure that level of Board assurance provided is commensurate with the assurance procedures actually undertaken and the outcome of that assurance.

For example, any statement on significant bill increases will rely on a sample based selection of customers with notional levels of consumption. Last year we did not have any sample customers with a bill increase of more than 5% and therefore the Board was able to sign a simple statement to that effect. In future years, it is likely that there could be changes above the threshold. We would recommend that the Board statement is reflective of this limitation. Similarly, the company would define any required handling strategies and hence any associated changes in policy it deemed to be significant. Again we would recommend that the Board statement should reflect this situation.

We would be happy to provide an evaluation of the impact of any changes to Ofwat and to CCW if required but would not expect to place these in the public domain.

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

The primary purpose of the Board statement is to provide assurance that the Company has materially complied with its legal obligations. This is fully covered by the requirements.

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

As discussed in response to question 4, we are happy to share a statement on significant changes with Ofwat and CCW. We do not think that there would be a significant problem with providing this in advance of the scheme itself; any changes will have been through our own internal approval process and discussed with CCW before final charge values are confirmed.

7. 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?

Our responses to questions 8 and 10 cover publication of non-primary charges and early publication of schemes. Some of the other proposals are discussed below.

4.1.3 Special agreements

We agree that retail services for customers with special agreements should be contestable. Our tariffs are designed to ensure that retail costs and an appropriate margin for these customers is allowed in full; the whole cost of historic discounts is borne by the wholesaler.

Our special agreements take a number of forms, as required by the legislation or contract under which they were created. For example:

- Discounted rates tied to current charges.
- Discounted rates that are fixed permanently or determined in some other way.
- Exemption from some charges.
- A volume of water or waste that is not charged.

It will be possible for us to calculate an effective percentage discount for each agreement or each charge, but in some instances this will be variable and depend on estimates. For example, where the first x cubic meters of water are free the effective percentage discount that we publish will depend on an estimate; the true discount will differ depending on what the customer actually uses. Including this percentage as a driver in any calculation of charges (as proposed for the market settlement system) will therefore lead to differences that will need to be corrected.

4.1.5 Separate highway drainage charges

When we started our site area scheme, we included a split between surface and highway drainage in the charge. Based on our historic experience, separate billing of highway drainage charges only generates negative customer contacts and complaints along the lines of:

- What this charge is actually for – the common misconception being it that it is for the road outside the customer’s property;
- What they can do to reduce their liability – the answer being nothing as long as their property continues to be connected to the sewerage network; and
- Why they should have to pay more than others.

All of the above were instrumental in our decision to remove highway drainage as a separate element of charge in 1997 and instead recover highway drainage costs as an ‘on-cost’ within the other two sewerage services, namely foul sewerage and property surface water drainage.

As we explained in the introduction to this response, we think information is a powerful tool to drive better decision making. The publication of charging components is one way in which we have sought to drive behavioural change – for example:

- Charging by volume creates an incentive for customers to reduce their consumption.
- Site area charges for surface water drainage create an incentive for customers to reduce the impermeable area of their property that drains to the sewer.

In both instances, the form of the charge can create a positive change in customer behaviour and this, in turn, can reduce cost and deliver environmental benefit. This is because customer behaviour drives the cost and thus changes to behaviour will change the level of the cost.

With Highway Drainage, no change in customer behaviour will change cost. Customers do not give rise to the costs associated with highway drainage – instead it is the investment decisions of local authorities and the Highways Agency. For this reason highway drainage costs are, in effect, a tax on sewerage customers. We see no reason why this cost should be represented as a separate item on a bill rather than any other tax such as rates or national insurance.

There is no “correct” way to charge, but two approaches have been used to date:

- A flat rate for all, which operates like a “poll tax”. This is a regressive approach, imposing proportionally higher costs on smaller customers. For ourselves, this approach would require a specific new charge of around £10 to be added to all bills. Because we do not currently have a fixed element for some charges such as unmeasured households, a change at wholesale level would generate a visible change in customer bills.

- A charge linked the surface water charge, based on site area. This is more progressive but the link with the use of roads is very questionable – as noted, our experience was that customers often asked why they should pay more for this service if they could point to customers with smaller sites who made more use of the road network.

With the second option there are particular issues for customers that have no connection for surface water. It is difficult to argue that such customers should be exempt from highway charges. For ourselves this option would involve adding potentially large charges for these customers; if highway costs are roughly half of all surface flows then customers with the largest properties could see a new charge of around £60,000. With both these options a change in the wholesale scheme would produce a visible effect in end-user charges.

We also think that separating this charge will generate additional costs (without a commensurate benefit). For example this requirement will require changes to billing systems. Depending on the option selected, it could give rise to at least 10 additional household charging bands and at least 30 non-household tariffs. This will clearly add a lot of complexity to the scheme of charges.

At the DEFRA charging workshop it was suggested separate charges would be beneficial to alternate retailers. Leaving to one side the fact that it's not apparent how retailers would be able to use this data, there are other ways of providing the information. For example one option would be to provide the relevant authorities and (potentially retailers) with an annual (published) report that sets out the costs that road agencies impose on the sector. Such a report would then provide a useful basis for engaging with these authorities on future investment plans.

If Ofwat introduces this rule, even on a pilot basis, we think it should:

- Articulate the outcome that it is trying to achieve and evaluate the benefits it will create. We do not think that the consultation has made this case.
- Set out its view of the charging principles that should be applied in order to allocate the charge.

As we have discussed, highway drainage is effectively a tax. The two methods that have been used to allocate the tax to date produce a radically different distribution. Ofwat has stated its preference for moving towards site area charging for surface water – if it must be separated we think Ofwat should also provide a view on the correct driver for highway drainage.

We think the industry would welcome the opportunity to discuss this further and suggest that Ofwat should organise a workshop to discuss this proposal. We do not think the pilot scheme should proceed until all of the options for highway drainage have been considered.

4.1.6 Standardisation of charges

We think that simplicity in charging is an important objective. Recent changes have driven greater complexity in charges than the industry has seen before:

- Multiple revenue controls (and different forms of control) replacing a single price control;
- Changes in the control within period due to Outcome Delivery Incentives and (potentially) an amended Wholesale Revenue Forecasting Incentive Mechanism;
- A clear divergence between household and non-household charges at both retail level (due to differences in margins and retail costs) and wholesale level (due to Open Water charges);

There are other potential regulatory changes that could drive even greater complexity as noted in the section above. Given this background, we are considering how Severn Trent can offset these effects by reducing the number of different charges at wholesale level.

We understand that the diversity of charges introduces an administrative burden for retailers – particularly those who will want to consolidate bills for national customers. But each site will be served by a single regional wholesaler and this wholesaler will not change. It should therefore be within the capability of the retailer to understand the tariffs for the customers they serve and add value by removing this burden from those customers. Provided wholesaler charges are transparent and changes are signalled to retailers in good time, we do not think this is unduly burdensome.

Standardisation of charging structures between regions could generate substantial incidence effects on customers. There could also be other unintended consequences. For example, some companies have adopted tariffs that are designed to manage demand and these are justified in terms of the regional resource position. Removing them could have consequences for the companies' water resources and the environment.

Therefore we are happy to work with Ofwat to reduce complexity and bring about a degree of convergence. However, we think this needs to be approached in a measured and careful way, taking account of all consequences and dealing with transitional effects appropriately.

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

Given the requirements of the Market Code, we are working to include non-primary charges within our Scheme. We think that the wording of our scheme will have to make clear that we are providing a list of standard charges, but that some services will have to be negotiated on an individual basis. For example, non-standard meter installations are – by definition – non-standard and we would have to take account of the actual costs in these cases.

In principle, this is not dissimilar to the indicative access prices that we already publish – we provide an indication of price at a give volume, but the actual discount will depend on the services required; the discount for combined access will also depend on the area where a supply is made.

9. 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?

At Severn Trent we place a lot of importance in our assurance process – this is particularly relevant when it comes to assuring our charges. Given that the RPI for November is not made available until the second full week of December (15th December this year), there is already little time to complete and assure final charges before publication. For this reason we do not think it would be practicable to publish assured charges earlier than the first working day of February.

We think the wording of this question may cause a little confusion as it implies that charges need to be published in the first week of January. The draft rules ask us to provide information to Ofwat in January, three weeks before we put a Scheme of Charges onto our website – this is not publication. We are content with the timetable included in the rules.

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

We understand retailers would like to have certainty in order to put together their pricing strategy, but we question:

- The value of early charges for planning, given that wholesale charges cannot be finalised until November RPI is known;
- The extent to which this desire should constrain wholesalers' ability to respond to new and better information; and
- Whether this aim could have unintended consequences for the market (and for customers).

As noted response to the previous question, we place a great deal of importance on assurance. As a public company, we could not publish any information on our charges without going through a proper process. So a requirement to provide an early draft of our scheme would not be without cost.

In addition, there will be a reduction in the quality of the information available to us for each early publication. When compiling past years' charges, we have taken into account billing data up to the end of November. Given the assurance timetable, the implication is

that an October publication would be based on data up to the end of July and the July publication would essentially be based upon the previous financial year.

Any early publication would require us to include an estimated RPI value. We are very concerned at the suggestion that the variation between October and January charges should be limited to the variation in RPI alone:

- Firstly, as noted above, this would mean that we only take account of information obtained up to the end of July – 8 months before the start of the charging year. Given that we could incur penalties for inaccurate forecasts under the WRFIM, a restriction on our ability to use newer data could have financial consequences.
- Secondly, even if did not use newer information, charge setting requires us to balance multiple constraints. The difference between draft and final charges might be more complex than simply adjusting all wholesale tariffs for the difference in RPI.

We also think that early publication could actually be detrimental to the market because, if it comes with constraints around future changes, it would prevent the wholesaler from reacting to feedback from retailers and customers.

Given the limitations of the information available, we think early publication – particularly in July - would have very low value to retailers. At most it could provide an indication as to the future direction of the wholesaler's pricing strategy and general changes in policy.

Charges in the water sector are generally quite stable. Large incidence effects can be driven by regulatory changes but other rises tend to follow the rate of inflation (which retailers can observe) and price limits (which are published). There are few markets where retailers or customers have greater certainty over future pricing 8 months or more before they are put into effect. Genuine fixed prices – which provide retailers with real certainty - are common in the energy market but retailers entering into these arrangements pay a premium in order to reduce their risk.

While we could provide this information, we would be very concerned about any suggestion that additional constraints should be placed on our final scheme of charges. And, if the draft schemes are not binding, we are not certain how valuable the information would be compared to the regulatory burden imposed.