



Wholesale and retail charges consultation

Strategy & Regulation

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Dear Ynon

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

We welcome the opportunity to respond to your charges scheme rules consultation.

We highlight below our comments on the more significant points raised in the consultation, and we include our detailed responses to the consultation questions in the attached appendix.

In determining charges scheme rules Ofwat's must reflect the four overarching objectives set out in in the UK Government's draft guidance:

- *"fairness and affordability;*
- *environmental protection;*
- *stability and predictability; and*
- *transparency and customer-focused service".*

Whilst we support the majority of the proposed charging rules, we are concerned in two ways. First, there are a small number of important areas where we believe that Ofwat should reconsider its proposals (as we set out below), and second, we think Ofwat should be more cautious about increasing the complexity of charges at the same time as endeavouring to expand competition. Customers will get more benefit from competition if charges are straightforward and sensibly structured and we believe that Ofwat should consider this explicitly when deciding on the charging rules.

Section 1 of the consultation confirms that companies' charges schemes must comply with the charging rules set by Ofwat. To facilitate this charges rules must be logical, unambiguous, consistent with each other and with other legal obligations of both Ofwat and companies. It may be difficult to comply with certain rules, for example rule 13, which states "*charging structures must*

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reflect the long run costs associated with providing the service” which could potentially run contrary to the duty to promote the efficient use of water. We consider that in assessing compliance, rather than companies being held to account for each individual charging rule, that charges schemes are assessed against the charging rules as a whole. The important areas that we consider require more attention are detailed below as follows:

1. Significant bill increases 5% threshold

We remain of the view that a 5% bill increase threshold, including inflation, does not necessarily represent a “*significant*” level of increase, the term used in the Defra charging guidance consultation. However, we are of the view that, even if the 5% threshold remains, a *de-minimus* value in the movement of customer bills should be set under which a proportionate impact assessment and publication in a ‘statement of significant change’ is not required, for example, where bills increase by less than say £10 on the basis that the value of the bill increase is relatively small.

2. Surface water rebates

Ofwat’s draft charging rule 20 goes further than the Defra draft guidance consultation document, section 4.11, which states “*where a customer can demonstrate that their surface water does not drain into the network they are entitled to a surface water drainage rebate*”. The Defra draft guidance puts the responsibility on the customer to request a rebate and charging rules should have regard to Defra’s guidance.

3. Timing and publications

We appreciate that the early release of wholesale information is important to retailers in setting their end-user charges. However, this is only useful to retailers if it is accurate. Given that the initial estimate of the revenue requirements for Bazalgette Tunnel Ltd, the Thames Tideway Tunnel Infrastructure Provider (TTTIP), is not due until 1 August each year, we have significant reservations with the proposal to require companies to publish “indicative” wholesale charges in July and final wholesale tariffs in October (subject to amending for actual inflation).

We consider that a balance needs to be struck between:

- the early publication of wholesale charges, for the benefit of retailers;
- the accuracy of forecasting the charge base multipliers (e.g. property numbers, metered volumes etc);
- the availability of essential information (such as the TTTIP charge) inherent in the charge setting process; and
- the duplication/triplication of work required in producing tariffs and charges schemes.

The publication of final wholesale tariffs in October (subject to amending for actual inflation) would have the effect of moving companies' charge setting processes forward four months, including assurance sign-off and Board approval and reduces the time available for companies to develop new/innovative tariffs. An additional point to note, specific to Thames Water, is that the final TTTIP charge, to be included in our wholesale wastewater tariffs, is not due until 24 December.

The introduction of the wholesale revenue forecasting incentive mechanism ("WRFIM") in AMP6 penalises companies whose actual revenue deviates from their allowed revenue by more than 2% to encourage companies to forecast accurately. Requiring companies to artificially freeze their wholesale tariffs in October (limited to amending for actual inflation) inevitably affects companies' ability to forecast accurately, so arguably justifies Ofwat revisiting the WRFIM parameters with a view to increasing the percentage variation allowance.

The proposal for companies to publish a statement of significant changes three weeks before the publication of charges schemes (on the first working day in February) would leave limited scope for Ofwat to "*engage with companies*" (section 3.2) in advance of their charges coming into effect.

4. Assurance requirements

We agree that it would be sensible to require companies to publish their Board's assurance statements alongside their charges schemes. Section 16 of the Water Act 2014 lists the areas that should be covered by charges scheme rules. We consider that the Board assurance statement should make specific reference to the fact that companies have complied with Ofwat's charges scheme rules.

Appendix 2, Annex A1(d) of the consultation confirms the requirement for companies to include in assurance statements that they have consulted with Consumer Council Water ("CCW") about their proposed charges schemes in a timely and effective manner (as set out in draft rule 7). In addition Section 3.1, final paragraph, refers to the assurance statement requirement of "*engaging with its customers*". We consider that engaging with CCW, as the customers' representative, is appropriate in respect of the annual charge setting process, but that companies will also be required to undertake adhoc engagement with customers where necessary to support specific tariff development e.g. in support of social tariffs.

5. Future developments and next steps

Section 4.1.6 refers to Ofwat's intention to consult on a set of proposals related to standardisation of wholesale charges in 2015. If Ofwat confirms its proposal to require companies to produce indicative wholesale prices in July and final wholesale prices in October (subject to an inflation adjustment) then wholesale charges rules would need to be set in early 2016 if they were required to apply in the development of 2017-18 tariffs.

Companies must set tariffs to comply with price limits, relevant legislation and Ofwat's charging rules (which have regard to charging guidance issued by the UK Government). We agree with Ofwat's stated preference that it is not for them to design and specify companies tariffs but accept the premise that some level of standardisation of wholesale charge methodologies may be required over time and may be necessary to help facilitate competition within the retail market. Clearly the application of standardisation in wholesale charging structures, not least with the potential impact on customer bills as a result of how revenue is recovered from different customer groups, is a complex issue.

Standardising the methodologies for calculating some elements of wholesale charges, such as for surface water drainage rebates, or requiring the introduction of site area based surface water drainage charges, would be problematical if it were to lead to significant changes to companies' current charges schemes that resulted in significant incidence effects on customers' bills.

We note that Ofwat proposes to consult on, and set, charging rules for wholesale charges, developer service charges, access pricing and non-primary charges at later date. Clearly it is important for companies to be given as much notice as practicable, particularly if material changes to current charging practices are required.

Please do not hesitate to contact me or my team if you have any questions or comments on our response. We look forward to working closely with Ofwat in supporting the further development of wholesale and retail charges for AMP6.

Yours sincerely



Nick Fincham
Director of Strategy & Regulation

Appendix 1 – Detailed responses

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?

Specific comments:

Rule 6:

The value of this rule is unclear. It suggests that “*words and expressions used in these rules have the same meaning as in any provision of the Water Industry Act 1991*”, unless they don’t.

Rule 8:

Where a customer receives both water and wastewater services from an undertaker (as reflected on a single combined bill), it would be sensible for an impact assessment to be required only where the increase in the combined bill exceeds the specified threshold. It would be useful if the rule could make this clear.

We consider that the ‘significant bill increase threshold’ should exclude non-appointed income and be set in real prices rather than nominal i.e. exclude inflation.

We are of the view that even if the 5% threshold remains a *de-minimus* value in the movement of customer bills should be set under which a proportionate impact assessment and publication in a ‘statement of significant change’ is not required, for example, where the bill increase is less than say £10 on the basis that the value of the bill increase is relatively small.

Rule 13:

What does the term “charging structures must reflect long run costs” mean?

- If most costs are capacity related rather than throughput related – how should that be “reflected” in charging structures?
- It would be helpful if this rule could clarify whether if, say, 50% of costs are fixed does this require 50% of charges to also be fixed? For metered customers this would be directly contrary to giving customer maximum control over their bills and reduce the incentives for customers to conserve water. The move to this level of fixed charge

for metered customers would not be acceptable as it would cause significant bill increases to low volume consumers.

However section 2.3.1 of the consultation states that the requirement for “volumetric charges to form a larger proportion of the total revenue to be recovered than implied by short run cost” remains.

As there is potential conflict between rule 13, companies’ obligations to conserve water and Ofwat’s view that the volumetric charge should form the large proportion of revenue we consider that this rule should be amended.

Rule 14:

On the basis that this relates to a metered /unmetered household differential type calculation, does Ofwat propose to specify the components that should be included e.g. meter under-registration, supply pipe leakage, cash flow effects etc as it did previously?

Rule 17:

The current wastewater / trade effluent differential calculation aims to ensure a reasonable balance between metered wastewater tariffs and trade effluent tariffs. This rule suggests a requirement to go further, i.e. differentiating between the different pollutant loads for household and non-household customer’s foul sewage and charging on that basis. Given the significantly varying nature of non-household customers’ waste discharges, e.g. a restaurant versus a hospital, then it is difficult to see what value, in terms of fairness, this differentiation would achieve and would add additional complexities at the same time as competition develops.

Rule 18:

The section could more usefully be split between assessed charges for domestic (household) customers and assessed charges applicable to non-household (primarily business) customers.

For household customers the section would be clearer if it started with 18(b) i.e. when the charge may apply followed by 18(a) how the charge should be determined.

It could also then make reference to an assessed household charge being applicable as part of a universal metering programme where metering is not reasonably practical or too expensive.

Rule 20:

This goes further than the Defra draft guidance consultation document, section 4.11, which states “*where a customer can demonstrate that their surface water does not drain into the network they are entitled to a surface water drainage rebate*”. The Defra draft guidance clearly puts the responsibility on customers to request a rebate and we think that Ofwat should have regard to this guidance.

Rule 21:

We do not currently allow abated charges for partial non-return of surface water but will keep this under review. This may be more appropriate for non-household customers where surface area based charging is in place. Charges schemes fix the charges to be paid for any services provided by the undertaker in the course of carrying out its functions and make provision with respect to the times and methods of payment of the charges fixed by the scheme. Where companies do not give partial non-return allowances we do not think that charges schemes are appropriate documents for giving an explanation of why there is no such provision.

Annex : Information requirements

It is not clear whether the Annex is formally part the charges scheme rules with which companies must comply. For clarity we suggest that it would be more appropriate to continue with the charges rules numbering format to cover the information requirements.

A2 (Annex : Information requirements)

There are potentially many customer types, depending upon how a customer type is defined. A specific definition of ‘customer type’ should be included in the charging rules to ensure that companies can properly fulfil the requirement.

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 support encouraging customers to reduce their sewerage charges by diverting their surface water away from the main sewer e.g. by constructing a soak-away and which may play a part in sustainable drainage systems (SuDS) strategies. We also support the development of incentives to reduce the amount of surface water collected, particularly in combined sewers. In the case of sustainable drainage for new development, we consider that some legislative issues need to be resolved - namely the ability for companies to

adopt SuDS, powers to access them when they cross third party land and the potential use of SuDS to receive land drainage.

We also acknowledge that the industry needs to move towards fairer and more cost reflective means of charging for surface water in particular, in order to address climate change and urbanisation. Charging can, if used appropriately act as an incentive to reduce the amount surface water collected, particularly in respect of discharges to combined sewers. However, there are significant challenges involved and extensive and ongoing engagement with affected customers is key. Companies are best placed to lead this conversation with customers, to allow those customers affected to influence any changes that are made.

Moving to a site area-based charging approach for surface water drainage will inevitably create winners and losers, be expensive to implement and has the potential to be very damaging if not handled sensitively. Whilst it may make charges fairer, influencing customers to reduce the surface water draining to our sewers will depend on their costs in making alternative arrangement, retrofitting may be an expensive option. We would need to fully evaluate the costs, sustainability benefits and impact on customer bills (particularly given our large wastewater only customer base). Ofwat's bill increase threshold, which requires an impact assessment and the demonstration of what mitigation actions have been taken, where bills increase by more than 5%, could make the transition to site area based charging difficult, and we will consider how best to take this forward.

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?

Defra's consultation on charging guidance to Ofwat (section 2.11) refers to the requirement to "*undertake a proportionate assessment of the impacts of any significant incidence effects on customers*". However the guidance does not quantify what "*significant*" means and we remain of the view that a threshold of 5% (including inflation) is too low.

We consider that the stability and predictability of bills, particularly to household and small business customers, is important. We also take the view, that where reasonably practicable, any significant changes that are required to tariffs should be phased in to ensure that customers continue to face predictable and stable bills. However, where there are unavoidable circumstances, such as future bill increases as a result of Thames Water's wastewater charges including the TTTIP charge, exceptions to the 5% rule should be made on a case by case basis.

The 5% cap, particularly when applied at the service level, allows very little flexibility, reduces the potential for innovation and the ability to make tariffs more cost reflective.

As referred to in our response to question 1 we are of the view that, even if the 5% threshold remains, a *de-minimus* value in the movement of customer bills should be set under which a proportionate impact assessment and publication is not required e.g. where the bill increase is less than say £10 to remove the requirement for customers to be included in the proposed 'statement of significant change' where the value in the increase of their bills is relatively small.

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

We agree with the requirement for companies to publish their Board's assurance statements alongside their charges schemes.

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

Section 16 of the Water Act 2014 lists the areas that should be covered by charges scheme rules. We consider that the Board assurance statement should make specific reference to the fact that companies have complied with Ofwat's charges scheme rules .

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

We agree with the proposed requirement to prepare and publish a 'statement of significant changes'. We welcome the opportunity to engage with Ofwat on our charging proposals but have some concerns regarding the timings suggested in the consultation document. The proposal for companies to publish a statement of significant changes three weeks before the publication of charges schemes (on the first working day in February) would leave limited scope for Ofwat to "*engage with companies*" (section 3.2) in advance of their charges coming into effect.

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?

We do not consider it appropriate for 'non-appointed' charges to be included in company charges schemes at all, although an exception would be the TTTIP charge which will be a component of Thames Water's wholesale wastewater charges.

End-user charges are made up of wholesale charges and retail service charges (cost to serve plus net margin). Ofwat refers to setting rules for on wholesale charges next year (section 1, page 7) although we would expect that the vast majority of factors that affect the wholesale component of end-user charges will already be included in scheme rules for 2016-17.

Our concerns over timing and publication are outlined in our responses to Q9 and Q10 below.

Standardisation of wholesale charges

Section 4.1.6 refers to Ofwat's intention to consult on a set of proposals related to standardisation of wholesale charges in 2015. If Ofwat confirm their proposal to require companies to produce indicative wholesale prices in July and final wholesale prices in October (subject to an inflation adjustment) then wholesale charges rules would need to be set early in 2016 if they were to apply in the development of 2017-18 tariffs.

Companies must set tariffs to comply with price limits, relevant legislation and Ofwat's charging rules (which have regard to charging guidance issued by the UK Government). We agree with Ofwat's stated preference that it is not for them to design and specify companies tariffs but accept the premise that some level of standardisation of wholesale charge methodologies may be required over time.

Any future standardisation of wholesale charges would need to be handled very carefully. Companies' current charging structures often vary considerably for example in;

- the fixed and variable charging components,
- the band thresholds for non-household metered tariffs
- the way that rebates such as surface water drainage are calculated
- how surface water and highway drainage are recovered through wastewater charges (via the fixed and variable components)

Any requirement to standardise tariff structures or charging methodologies is likely to result in significant incidence effect in some customer bills and would need to be handled very carefully.

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

Where non-primary charges (i.e. charges for non-primary service such as disconnection, meter testing, provision of fire hydrants, pressure tests etc) are for non-appointed activities, or are outside the wholesale allowed revenue

price controls, we consider that it would not be appropriate for them to be included within wholesale (or end-user) charges schemes.

Where they are for appointed business activities, but outside of allowed revenue controls, they should be published on company websites but under separate cover.

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?

The timetable for the publication of final non-household wholesale charges in the first week of January reflecting the November RPI (released around mid-December), and for Thames Water the inclusion of the final TTTIP charge, not due until the 24 December, is extremely tight. Non-household charges cannot be set in isolation of household charges (allowed wholesale controls cover both types of customer) and under the assurance process will require Board approval.

We suggest that wholesale non-household charges should not be required to be published any earlier than the 15 January.

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

We have significant reservations with the outline proposal for the requirement to publish indicative wholesale charges in July and October, although we appreciate that the early release of wholesale information is important to retailers in setting their end-user charges.

A balance needs to be struck between the early publication of wholesale charges, for the benefit of retailers, the accuracy of forecasting the charge base multipliers (e.g. property numbers, metered volumes etc) applicable in the charge setting process and the duplication/triplication of work required in producing tariffs and charges schemes.

Publication in October will have the effect of moving companies' whole charge setting processes forward four months, including assurance sign-off and Board approval and reduces the time available for companies to develop new/innovative tariffs.

The introduction of the wholesale revenue forecasting incentive mechanism ("WRFIM") in AMP6 penalises companies whose actual revenue deviates from their allowed revenue by more than 2% to encourage companies to forecast accurately. Requiring companies to artificially freeze their wholesale tariffs in October (limited to amending for actual inflation) inevitably affects companies'

ability to forecast accurately, so arguably justifies Ofwat revisiting the WRFIM parameters with a view to increasing the percentage variation allowance.

In our view the publication of a single set of indicative wholesale tariffs in October, which are not subject to any restriction on further changes, may be appropriate. An additional point to note, specific to Thames Water, is that the final Thames Tideway Tunnel Infrastructure Provide Charge, to be included in our wholesale wastewater tariffs, is not due until 24 December.