Consultation on Charges Scheme Rules for 2016-17 and Future Developments

Yorkshire Water Response

Section 1. Background and Context

1.1 Our Duties and Obligations

You list existing charging duties and obligations and include Conditions B and E as well as Government Guidance and Competition Act 1998.

Conditions C, D and R (eg paragraph 6) are currently missing from the list. They are important and we think they should be included in any list of company duties and obligations, no matter how partial the list may be. Furthermore, under your description of Condition E you omit the fact that this key Licence Condition also explicitly relates to charges made via special agreement – important given your consultation in section 4 extends to cover charging via section 142 special agreements.

The WA2014 – section 66E(3) and section 117I(3) - now appears to contain its own Condition E related text - namely that such "access" charging rules must include provision "*to enable the licensee…where…the services….are services to which a section 142(2)b agreement would apply….to charge for those services at the same rate or rates as would have applied if the section 142(2)b agreement had applied*". This appears to reflect the general thrust of our Condition R(6).

1.2 Your Duties and Obligations

We understand that Ofwat wants "*to enable greater company ownership and innovation **while also** allowing us to set out the principles (as reflected in our rules) we consider important for customers*". We hope this dual strategy for charges stewardship will continue to be kept in mind when you "*make further changes to [y]our charging rules in future years*".

We recognise that Ofwat itself has a secondary charging duty to "*secure that no undue preference is shown, and that there is no undue discrimination in the fixing by such companies of water and drainage charges*" (WIA91 3b). This Condition E equivalent duty remains in place and has been highlighted in Defra's draft charging Guidance (see section 2.5). And this key duty should probably be mentioned in background to all future charge rule related consultations as it provides important regulatory context: both to the proposed charging rules and the requested board assurance and associated information (eg the need for regulatory notification of substantial charge changes).

The shift from ex post regulation to ex post action – which had, to some extent, already happened prior to the new framework - does not impact on the Regulator's secondary duty in this charging policy area. And hence we look forward to commenting on "*new rules regarding the structure of charges, and how costs are allocated between services and customers*" - that will then help you "secure" that there is no undue preference/discrimination in company charging - "*over the next few years*".

Our understanding of your secondary WIA91 duty to "secure" that company charges are fair strongly influenced our short - and affirmative - responses to the questions (Q4, Q5, Q6) raised in section 3.

Section 2. Charges Scheme Rules

We think it helps to structure the policy discussion around the Government's four overarching charging objectives. In our view Ofwat's charging rules need to targeted and proportionate. And as proposed we think they are.

2.1 Nature of Rules

There is clearly a tension between setting out general charging principles and providing explicit charging rules. For example, some proposed rules are clearly open to our interpretation and may only become definitive when regulatory action is taken for company failure to fulfil their general spirit.

For example:

- Under Rule 7 - what is a "timely and effective manner"?
- Under Rule 8 - what is a "proportionate impact assessment"?
- Under Rule 10 – what is a "such other manner"?
- Under Rule 20 – what does "should reasonably have known" mean?
- Under Rule 21 - what is a "significant amount"?
- Under Rule 24 - what is a "reasonable choice"?

We do not think this is not a major problem – noting that these charging rules may not be used to limit our total revenues from charges fixed in accordance with a charges scheme.

But some recognition that the charging rules may be both "soft" (ie principle-like and open to company interpretation) and "hard" (ie a must do), might aid their conceptualisation. Indeed individual rules may shift between "hard" and "soft" as issues rise up and down the regulatory agenda. If sensibly managed we would support such rule flexibility.

The outcome of some proposed rules – especially on cost allocation matters - are also dependent on their detailed animation. A charge may be based on differential peaking factors. But that does not mean to say that it is a fair charge - as this will depend on how, for example, other customer class demand characteristics - such as economies of scale - have been accounted for in the allocation procedure. Assessing fairness will always require a degree of regulatory judgment.

2.2 Rule Coverage – "End-user" charges scheme

Ofwat states that "*the rules will be made under sections 143(6A) and 143B of the WIA91 and are **limited to end-user (retail)** charges schemes*". We seek clarification on this particular matter.

Under the WIA91 and Condition D we believe we can only have one charges scheme. And under such a charges scheme we can " *fix the charges to be paid for any services provided by the undertaker in the course of carrying out its functions"* (excepting where charges are made via section 142 agreement).

We are currently not sure why the charging rules for charges schemes are to be limited to "end-user" (retail) charges – noting that "end users" are very broadly defined in Condition B as "*a*

customer of the Appointee or a user of the goods or services concerned", but exclude Licensees and Appointees.

These "end user" charges may be deemed by the Regulator to cover all the charges that we are currently allowed to recover under the WIA91 (section 143), noting for example, that infrastructure charges (section 146) also form part of our charges scheme envelope. Or the Regulator may be making a conscious decision to currently limit its charges scheme related rule making powers to only cover said "end-user" charges - and not, say infrastructure charges, which are to be addressed elsewhere, or others, say miscellaneous charges that will not be addressed. We believe it is the latter but seek clarity.

Furthermore, we think having "*a separate set of rules about wholesale charges*" may create a sense of overlap and potential for inconsistency. But this may be unavoidable. For example, we note that a large number of the proposed "end-user" (retail) charging rules (eg rules 13-17 and 20-22) directly relate to wholesale costs of the associated wholesale activities provided. A number also relate to the wholesale charge relationship between the non-household and household customer classes. So many of the proposed retail charging rules relate directly to the associated wholesale activities - and will probably need to be replicated for wholesale charges - and cover the charge relationships between non-household and household customer classes.

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?

Wastewater Charges – Drainage Rebates

We only comment on two of the newly proposed rules.

Proposed rule 20 states that we should offer a full drainage rebate "*where the sewerage undertaker knows, or should reasonably have known, that surface water does not drain to a public sewer from those premises*".

We will continue to rely on customer applications as this is the most cost effective means of managing the abated charge.

Proposed rule 21 states "*Sewerage undertakers **must set out** in their charges schemes how any reduction in the charges payable for the provision of sewerage services to any premises will be calculated if customers can demonstrate that they have significantly reduced the volume of surface water draining to a public sewer from their premises or explain why there is no such provision*".

In RD 35/03 Ofwat stated: "*Previously, Ofwat has supported water companies that have adopted an "all or nothing" rule to surface water drainage charges. So, for example, customers who had some, but not all of their surface water diverted away from the public sewer by whatever means, were seen to be connected and liable to pay the entire charge for SWD. We have reviewed our position on this issue.*

*We would **encourage** companies to offer partial rebates for customers who can prove that some of their surface water drains away from the public sewer. We recognise that there may still be difficulties in ascertaining the level of rebates to which a customer is entitled. And we acknowledge*

that there may be an inconsistency between offering a rebate based on surface area when the customer is charged for SWD by another method (e.g. RV). Indeed, this is a further argument in support of site area based charging. Where companies do not allow customers to gain a partial rebate, they offer no incentive for customers to reduce the surface drainage costs that they impose.

We consider that it is more appropriate to offer partial rebates to non-household customers because the unit cost of administering a partial rebate is lower than it is for households."

And some of this RD 35/03 text remains in your current charging guidance (see section 5.3).

We would welcome further information on why the current binary approach for households is now deemed inappropriate. In particular we would like to understand the Regulator's views on the costs of implementing such a policy shift (essentially from optional to mandatory partial rebates) and how this has been considered as part of the PR14 settlement. We would also welcome a view on how the consequential inconsistencies referred to above can be minimized.

We will not be introducing such partial drainage rebates for 2016-17 and will explain our reasons in the charges scheme. These reasons may relate to poor average cost justification, the weak incentive properties and the resulting inconsistencies that will result if partial rebates are offered. More importantly this proposed charging rule change will not be confirmed until early November 2015. Given our experience in implementing area based drainage charging in 2000-01 we think the notification period - of less than 2 months if wholesale charges are then due to be published in early January 2016 - to implement such a change in drainage charging policy is simply too short.

Non-Household Default Tariffs

Proposed rule 25 states that "*charges schemes must include the types of charges for end-users (known as default tariffs) listed in the first column of table 6 of the notice given by the Water Services Regulation Authority on 12 December 2014 "*.

In our view this rule will essentially ossify the default tariff structure to that which existed at the time of PR14. We assume that if the wholesaling arm of a company decides to change its wholesale tariff structure (say by adding a further more cost-reflective threshold) then the current default tariffs will not be allowed to change accordingly? We think this rule will not help improve charging innovation.

Ofwat have previously stated that "*As we said in section 2.1, companies will be allowed to change the charging variables of the default tariffs (subject to complying with their duties, obligations, and the average revenue controls). For the avoidance of doubt, while our final determinations will set out the average revenue controls with which companies must comply per tariff band, they will not place restrictions on how companies structure their charges***".** This could have been interpreted as giving companies more flexibility in how they could develop and structure their default tariffs; noting that for the current charging year we have followed our table 6 listing to avoid such regulatory risk and uncertainty.

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 participated in a telephone conference earlier this year with Cathryn Ross to help the Regulator understand what lessons can be learnt from companies that have already introduced site area-based surface water drainage charging. We can forward a confidential summary of the lessons learnt if required.

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

Yes we agree with the proposed threshold. But we also note that bill increases of less than 5% can compound over a longer period and this also needs to be monitored (see UKWIR report on wholesale and household retail charging principles for suggested bill impact trend analyses).

Ofwat has stated previously that: "*In the longer term, we would expect companies themselves to identify when impact assessments may be required without a uniformly-set threshold, and to carry them out accordingly. This would be in line with our progressive trend to a more risk-based approach to regulation, with us only intervening as a 'safety net' where required*".

We would support a "softer" bill stability rule along these lines. In 2015-16 we looked at the impact on bills for all of our customers. And we are pleased that you have made the following potential commitment, namely "*If appropriate we will include provisions for companies to take a different approach if they can demonstrate that a different approach would better serve their customers (and if they get our agreement to this in advance)*". We believe such text should be included as a supplement to the current "hard" 5% rule.

Section 3. Assurance and Information requirements

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?

No.

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

Yes.

Section 4. Future Developments and next steps

In due course – namely when the costs principle is withdrawn - Ofwat "must" now issue rules about such section 117E and 66D agreement related charges that may be imposed on any licensee.

However, we are not sure that these particular charge rule making powers can be extended to fully embrace: i) "*the provision of wholesale water and sewerage services by the water company*" across non-household and household customers served by the Appointee – excepting the publication of said wholesale charges under Condition B; or ii) "*special agreements*".

And this uncertainty in the wide-scale applicability of Ofwat's rule making powers for section 117E and 66D made agreements is reflected in our feedback below.

4.1.1 Completeness of Wholesale Charges Schemes

Charges may be imposed by undertakers for services explicitly provided under a section 117E and/or 66D agreement (and potentially under section 66M regulations). Historically these "access" charges have been indicative and published separately in our access codes on October 1.

Our current opinion is that these "access" charges are distinct - as these charges will be made under section 117E/66D agreements as opposed to being published in our charges scheme - but obviously directly related (ie typically equivalent), to our standard wholesale service charges that will have been developed and published for price control purposes.

You state that "*we took the view that that wholesalers should not charge retailers in the non-household market for any wholesale service sold in the market using a charge that is not published in its* ***wholesale charges scheme***". And that you "*are minded to set a future requirement to publish a clear and complete* ***wholesale charges scheme***".

We do agree with the underlying policy position – namely that wholesale charges should be clear and complete. This year we published a separate wholesale "charges scheme" - that included both household and non-household wholesale charges. And we believe this aids charging transparency, helps to ensure that Condition E for wholesale services is met and assists in assessing wholesale price control compliance.

Indeed to further improve transparency we are currently minded to attach a full list of our published wholesale charges to our company charges scheme. This would also provide a solution by which Ofwat would have charges scheme related rule making powers and these charging rules – covering both wholesale and retail services - could then be easily made to marry up.

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

As noted in the above discussion about "end user" charges scheme rule coverage, there are some terminology issues to consider.

Whilst we are supportive of complete charge transparency in the wholesale arena, both the WIA91 and Condition D refers to "a charges scheme" in the singular. We therefore think it may be

appropriate to call the published wholesale charges document something different – a wholesale price list or charge schedule - so as to distinguish it from our formal published charges scheme.

We think this wholesale price/charge list/schedule should include all charges (household and non-household) included in the wholesale price control to help demonstrate compliance with the said price control. And the non-household wholesale charges can then be used for the central market operating system.

However, we also think that it would not be desirable to include non-primary charges in such a wholesale price list/schedule unless they are also included in our formal charges scheme. They should continue to be published in our formal charges scheme as this enables us to "*fix the charges to be paid for any services provided by the undertaker in the course of carrying out its functions*".

4.1.2 Timing of Publication of Wholesale Charges

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 note that Ofwat has previously concluded that "*we consider one month should provide enough time for new entrants to fine tune their own retail charging proposals ahead of the new charging year, taking into account the wholesale charges*". And we think that this is a reasonable timeframe and the first week in January is an appropriate requirement.

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

You have floated a more detailed proposal to "*publish indicative wholesale charges in July, and a second publication in October, which companies would not be able to revise but for upgrading of charges for the November RPI*".

You are essentially asking companies to develop a complete set of indicative wholesale prices (as it is not possible to look at non households in isolation) just 3 months after activation of the previous year's charges on April 1. And then to publish binding wholesale charges in October around 6 months before they become active in the following April, which is three months after they are published as complete in January for a third and final time.

We do not think this is sustainable – either from a work load perspective or a price risk perspective.

We see no reason to depart from indicative wholesale charges being published in around October with final charges being published alongside our formal charges scheme at the beginning of each calendar year – with around one month separating wholesale price list/schedule publication (in the first week in January) and formal charges scheme publication (on 1 February); with the former potentially being appended to the latter to ensure appropriate Condition E coverage.

4.1.3 Special Agreements

Ofwat must issue charging rules about charges schemes.

But Ofwat cannot, as far as we can see, issue charging rules under WA2014 about charges currently made by agreement under section 142. This is important given Ofwat's apparent desire to restructure – or at least re-represent - the prices of all existing special agreements to include a wholesale and retail element.

Ofwat appears to want to use section 66E(3) and section 117I(3) of WA2014 to achieve this particular objective. These two sub-sections explicitly relates to rule making powers for charges for "access" agreements - and not non-household charges made by agreement under section 146. These two sub-sections may mean that when agreements come to an end and when requested, the wholesale charge must enable the licensee to charge "*for those services at the same rate or rates as would have applied if the section 142(2)(b) agreement had applied*". As Ofwat clearly states when negotiations start "*water companies will have to allow licensees a margin*".

However, these particular sections of the WA2014 does not, in our opinion, mean that Ofwat can propose two special agreement related charging "rules" that state:

- "*Where water companies have special agreements with customers the retail elements of those special agreements must be contestable*".
- "*Where water companies have special agreements with customers they must provide information about the wholesale charge component of the charge*."

Ofwat appears to be utilising its section 66E(3) and section 117I(3) access charge rule making powers to address all existing historic special agreements made under section 142.

Ofwat may "*want to ensure that the retail elements of special agreements are contestable and that customers on these agreements are able to participate in the market*". It is the proposed means of justifying said contractual intervention that we would like to question. We therefore seek further clarity under what statute Ofwat is proposing the above special section 142 agreement related charging "rules".

4.1.5 Disaggregation of wastewater charges into separate components

You state that "*you are minded to set a requirement for 2017-18 for companies to disaggregate their wholesale wastewater charges into these three separate components [foul sewage, highway drainage and surface water drainage]…and to publish disaggregated wholesale charges on a pilot basis in January 2016*".

We support this proposal on simple charge transparency grounds. Although we do think Ofwat's claimed price signalling and associated environmental benefits are rather generous.