

August 2014

**Setting price controls for 2015-20
Draft price control determination notice:
technical appendix A8 – charging**



OFWAT

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Overview

This document sets out the charging process for 2015-16, and the draft wholesale determinations in the price base required for setting charges. A summary of the responses to our consultation on wholesale and retail charges for 2015-16 and charges scheme rules is also included.

The draft determinations set out the total and average revenue controls with which companies are required to comply when setting their charges. It is then for companies to convert these into actual charges (both wholesale and retail).

As set out in the Water Act 2014, we will no longer be required to ‘approve’ companies’ charging schemes. Instead, we will set charging rules with which companies will be required to comply.

For 2015-16 we will require from companies to do the following.

- Provide information on their proposed charges so we can identify in advance any unacceptable bill impacts on customers, and seek to intervene on a risk-based approach where necessary.
- Provide their wholesale charges presented in a standardised format. This will help provide a degree of transparency to retailers, which should in turn lead to benefits to non-household customers as companies are able to more effectively compete for their custom driving down costs and/or improving service.
- Take clear ownership that their charges are compliant with all their duties and obligations (including competition law).

Companies will be required to publish their charges by **2 February 2015**.

Our intention is to issue the rules in the first quarter of 2015. However, we recognise that the legislation has not yet been commenced and the UK and Welsh Governments have not yet issued the charges guidance. We will need to revert to the existing approvals process in the event that the required legislation is not commenced. This would require companies to provide us with their charges schemes and assurances by **16 January 2015**.

A8.1 Background

As we confirmed in our methodology statement, we are setting separate controls for each company for:

- water wholesale services;
- wastewater wholesale services;
- household retail services; and
- non-household retail services.

This will require the companies we regulate to set charges separately for each of these controls. Also, the Water Act 2014 sets out changes to the existing governance arrangements for charges. We will no longer be required to ‘approve’ companies’ charging schemes. Instead, we will set charging rules with which companies will be required to comply. In making these rules, we will have regard to any guidance issued to us by the UK and Welsh Governments.

In January, we consulted with stakeholders on options for setting new charging rules and the associated governance arrangements.

We issued a second consultation in May, which set out our expectations for charging rules relevant to companies setting separate wholesale and retail charges in 2015-16, and our expectations for further changes in charging over the next five years and beyond. The responses to the second consultation are included in chapter A8.4.

A8.2 The process for setting charges

A8.2.1 Information requirements

In our ‘[Consultation on wholesale and retail charges for 2015-16 and charges scheme rules](#)’, published in May 2014, we confirmed that we would assess compliance with the price controls through the regulatory accounts and companies’ annual risk and compliance statements. We will consult in September on the regulatory accounting requirements and price control compliance requirements for 2015-16.

Alongside these draft determinations we have published a [spreadsheet template](#) for companies to complete and submit to us by **3 October 2014**. The spreadsheet will provide us with early visibility of significant incidence effects, and will enable us to have appropriate discussions with companies about their draft charging proposals before final charges schemes come into effect.

The spreadsheet also includes a standard schedule for presenting wholesale charges. It is considered that such a schedule will help provide a degree of transparency to retailers (when companies publish their wholesale charges), and will also help progress the debate on the extent and form that charging standardisation could take in the future to support effective markets. This in turn should lead to benefits to non-household customers as companies are able to more effectively compete for their custom driving down costs and/or improving service.

A draft of the schedule was proposed by a company and tested with an industry working group in February. We then consulted on the schedule more widely in our May consultation.

In response to the consultation, we received a large number of proposed changes by various different companies, including companies that were on the initial working group (see chapter A8.4). As such, we expect there will need to be at least one more iteration of the format of that section of the template before companies publish their wholesale charges for 2015-16. As part of their 3 October responses, companies should highlight any remaining aspects of the standard wholesale charges schedule that do not fit their charging structures, including clear proposals to address those issues.

In our consultation, we confirmed that companies will be required to publish their wholesale and end-user retail charges in line with our final determinations by **2 February 2015**. These will form the basis for reporting actual compliance for 2015-16 in July 2016. In future years, we will require wholesale charges to be published earlier to enable new entrants to develop their own retail charging proposals ahead of the new charging year from April.

A summary of consultation responses is included in chapter A8.4.

A8.2.2 The process for 2015-16

In our consultation, we stated that as a result of our current understanding of the expected timing of final Government guidance, we would not be issuing final rules for charges schemes before 2015.

We recognised that this would leave little time for companies to develop their charges between the publication of our rules and the publication of their charges. This is why we set out our expectations for 2015-16 charging rules in our consultation. These were firmly rooted in existing Government guidance and principles, as well as existing charging methodologies and guidance.

With the rule framework in place, companies will not require prior approval from Ofwat (although they may request a meeting to discuss their proposals if they so wish), and we will not be required to approve their charges schemes. If we consider that a company's charges scheme does not comply with the published rules, then we may issue a direction for the company "to do, or not to do, a thing specified in the direction".

While our intention is to issue the rules in the first quarter of 2015, we recognise that the legislation has not yet been commenced, and the UK and Welsh Governments have not yet issued the charges guidance. In the event that the required legislation is not commenced, we will need to revert to the existing approvals process.

In such circumstances, we will approve companies' charges schemes on the basis of having received assurance that the charges comply with the expectations we set out in our May consultation on wholesale and retail charges for 2015-16, and that the company is complying with all of its duties and obligations.

If it is necessary to revert to the approvals process, we will inform companies ahead of the New Year. Companies would then need to provide us with their charges schemes and assurances by **16 January 2015**.

Even though we may not require companies' assurances and charges schemes in January, we recommend that they have these ready in case the required legislation is not commenced.

A8.3 Wholesale charges

A8.3.1 Licence condition B

Licence condition B states that the wholesale control is of the form RPI+K (where K can be a positive number, a negative number, or zero).

RPI and K together limit the change in the charges to be levied by (and/or revenue allowed to) the appointed business in each charging year in respect of the wholesale activities concerned.

As wholesale controls have not been set before, a base needs to be established for the K to be set relative to. As can be seen in the [company-specific appendices](#), we have set K equal to zero for the first year of the control period (2015-16). Therefore, the base to which RPI+K needs to be applied is simply the allowed revenue as set out in the [company-specific appendices](#) adjusted for inflation.

In licence condition B, RPI is defined as the percentage change in the Retail Prices Index between that published for the month of November in the prior year and that published for the immediately preceding November.

Below, we set out below a notional base year using the preceding November RPI, rather than financial year RPI.

For more detail on the interaction between allowed and forecast revenue, see the risk and reward technical appendix.

A8.3.2 Draft determination wholesale revenue

Companies' allowed wholesale revenues as per our draft determinations, rebased using November 2013 RPI, are shown below. This includes figures for the companies that received early draft determinations, reflecting the new RPI figures.

Table A8.1 Allowed wholesale revenue, 2014-15 notional base (draft)

	2014-15
Anglian	
Wholesale water – allowed revenues (£m)	428.10
Wholesale wastewater – allowed revenues (£m)	644.36
Dŵr Cymru	
Wholesale water – allowed revenues (£m)	270.41
Wholesale wastewater – allowed revenues (£m)	362.46
Northumbrian	
Wholesale water – allowed revenues (£m)	391.39
Wholesale wastewater – allowed revenues (£m)	283.27
Severn Trent	
Wholesale water – allowed revenues (£m)	613.94
Wholesale wastewater – allowed revenues (£m)	696.34
South West	
Wholesale water – allowed revenues (£m)	190.43
Wholesale wastewater – allowed revenues (£m)	247.27
Southern	
Wholesale water – allowed revenues (£m)	165.76
Wholesale wastewater – allowed revenues (£m)	516.05
Thames	
Wholesale water – allowed revenues (£m)	814.72
Wholesale wastewater – allowed revenues (£m)	897.84
Thames Tideway - allowed revenues (£m)	43.96
United Utilities	
Wholesale water – allowed revenues (£m)	644.77
Wholesale wastewater – allowed revenues (£m)	759.83

	2014-15
Wessex	
Wholesale water – allowed revenues (£m)	163.18
Wholesale wastewater – allowed revenues (£m)	280.66
Yorkshire	
Wholesale water – allowed revenues (£m)	376.89
Wholesale wastewater – allowed revenues (£m)	467.75
Affinity	
Wholesale water – allowed revenues (£m)	262.25
Bristol	
Wholesale water – allowed revenues (£m)	84.51
Dee Valley	
Wholesale water – allowed revenues (£m)	20.27
Portsmouth	
Wholesale water – allowed revenues (£m)	31.95
Sembcorp Bournemouth	
Wholesale water – allowed revenues (£m)	33.51
South East	
Wholesale water – allowed revenues (£m)	181.58
South Staffordshire	
Wholesale water – allowed revenues (£m)	97.22
Sutton & East Surrey	
Wholesale water – allowed revenues (£m)	53.91

A8.4 Consultation responses

In our ‘[Consultation on wholesale and retail charges for 2015-16 and charges scheme rules](#)’, published in May 2014, we set out our expectations for charging rules relevant to companies setting separate wholesale and retail charges in 2015-16, and our expectations for further changes in charging over the next five years and beyond.

The consultation included a number of questions to stakeholders regarding the wholesale and retail charging framework. In total we received 19 responses, including:

- 15 responses from incumbent companies;
- two responses from water supply licensees (WSLs);
- one response from a new appointee; and
- one response from the Consumer Council for Water (CCWater).

Our consultation on wholesale and retail charges for 2015-16 and charges scheme rules included the following specific questions:

Q1 Do you agree with the proposed approach to the development of charging arrangements in the 2015-20 period? If not, please explain and provide evidence for your view.

Responses

There was broad agreement from respondents towards our proposed approach to the development of charging arrangements in the 2015-20 period. However, a number of respondents requested further clarity about particular points of detail, such as: how charging developments will affect households and non-households, the relative importance of objectives, and the interactions between average and marginal costs.

Conclusions

We will continue to engage with all stakeholders, providing further clarity as the details of our approach continues to develop.

Q2 Do you agree with the nominal 5% bill change as a threshold for undertaking impact assessments? If not, please set out an alternative threshold and provide evidence for this view. Should the same threshold apply to all customer types?

Responses

There were a range of responses to the proposal of temporarily using a nominal 5% bill change figure as a threshold for undertaking impact assessments. CCWater and a number of water companies supported the figure. However, a number of incumbent companies disagreed with the approach.

Frequently cited concerns were that the figure should be set relative to RPI and potentially K as well.

A WSL respondent considered that such an approach should apply to wholesalers as well as to retailers.

Conclusions

Linking a threshold to RPI and/or K would not address the fact that customers experience bills in nominal terms.

We consider it to be paramount that companies understand the impacts of bill increases on their customers. Perhaps the objection by so many companies is due to a misunderstanding of what a 'proportionate impact assessment' includes. While companies should ultimately own the content of the assessments and strategies, we expect them to cover:

- an identification of the extent that different types of customers are affected by any change;
- an assessment of whether it would be more appropriate to phase changes in over a number of years, and what the implications of doing so would be; and
- an assessment of the different ways change could be managed – for example, increased customer engagement in advance/an information campaign on the different payment schemes available.

Companies operating in a competitive environment would seek to understand the pricing effect on their customers to a far greater extent. We therefore remain committed to maintaining the nominal 5% bill change as a threshold for undertaking impact assessments for 2015-16. However, to reiterate, we intend for this to be a short-term measure (see below). 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. But the consultation responses suggest that we are not yet in such a position.

We agree with the WSL respondent that there should be a degree of bill stability consideration at the wholesale level, as significantly changing wholesale charges can result in changes in customers' charges (where the retailer chooses to pass on such changes).

For 2015-16, companies will be publishing their wholesale charges for the first time, and we will be running a process to assess any unacceptable incidence effects (see section A8.2.1).

We will review in future years whether formal requirements are needed at the wholesale level. Our initial view is that some form of control would be required (beyond licence condition E's no undue preference or discrimination requirement). Such a requirement could be in the form of wholesalers having to consult with a retailer panel in advance of any material change to their charging structures. We will further consult on potential options in due course.

Q3 Do you agree with such a threshold being a short-term measure? If so, when should Ofwat remove such a requirement?

Responses

There was general agreement for the measure to not be maintained into the long term.

However, CCWater disagreed with this, stating that it could “see no reason why the threshold should be used only as a short-term measure”.

Conclusions

We will keep the threshold under review, and only remove it when we are confident of a suitable alternative. We are not committing to a timetable because we will need to see how companies respond to the original threshold first. Ideally, we would like to see companies developing their own (nominal) thresholds based on engagement with their customers, with different thresholds for different customer types.

This may result in the industry threshold remaining in place for some companies, and being removed for others – depending on whether the company could demonstrate clear support from its customers for its own proposed threshold.

Q4 Do you agree with the draft schedule for presenting standardised charging schedule presented in appendix 7? If not, please provide alternative proposals.

Responses

A large number of incumbent companies stated that the draft schedule required amendments to fit their charges. As many companies were not specific, we have since contacted companies directly to gain more specific feedback (for example, to gain a breakdown of the exact meter sizes that would fit their wholesale charges).

Conclusions

The feedback we have so far received has now been incorporated into the standardised wholesale schedule included in the charging template (see section A8.2.1).

Q5 Should charges associated with Open Water and market readiness be included as a separate increment to the volumetric charge in the wholesale charging?

Responses

There was general support for the inclusion of a ring-fenced charge to cover any Open Water and market readiness costs within companies' charges. However, some companies questioned whether it should be a fixed charge rather than volumetric.

Conclusions

We remain committed to the view that there needs to be a transparent separate charge in order to demonstrate compliance with the Government’s principle that household customers “will not subsidise the development of competitive markets for business customers”. However, as long as companies’ charges are compliant with their duties and obligations, (and our charging rules), we are prepared to accept the charge not necessarily being volumetric – if the company suitably explains why an alternative is more appropriate.

Q6 Beyond 2015, do you agree that wholesale charges should be published in advance of retail charges? If so, please provide views on how far in advance is appropriate.

Responses

There was general support for wholesale charges being published in advance of retail charges beyond 2015.

There was variation across responses as to the exact date. A number of respondents suggested mid-January for the publication of wholesale charges. The two WSL respondents suggested a gap of six weeks to two months. A number of other respondents suggested there needed to be a gap of one to three months.

Conclusions

A mid-January publication of wholesale charges would only leave two weeks before the publication of retail charges.

As wholesale charges are linked to November RPI (which is published in mid-December), and some companies start to issue unmetered bills at the start of February, it is not possible to have a two-month gap.

We do, however, consider that it is possible for wholesale charges to be published in the first week of January (beyond 2015). Charges could be developed in advance of the RPI data becoming available; we do not consider it would take long to adjust for any discrepancy between forecast and actual. Companies will need to assess how this interacts with their current internal assurance procedures.

This will result in wholesale charges being published one month in advance of retail.

Clearly there is an interaction between the required length of time and our position on question 2 – as the more stable (or predictable) the wholesale charges are, the more they can be predicted in advance. Given our position on wholesale charge stability, we consider that 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.

Q7 Do you consider that Ofwat should require retail water bills to provide a breakdown of retail and wholesale charges?

Responses

There was widespread agreement that there should not be a requirement for water bills to provide a breakdown of retail and wholesale charges.

Conclusions

In our consultation, we highlighted many of the reasons against introducing such a requirement. These included potentially reducing the incentive for retailers to challenge wholesale costs (as any savings would become transparent or as customers could see the wholesale charge as a cost pass through), and reducing company ownership in how bills are presented. We also noted that while there is not currently a requirement in the contestable Scottish non-household retail market or the energy sector where both household and non-household services are contestable some companies in those sectors already split their bills to present this information to customers.

While we remain of the view not to introduce such a specific requirement, it is vitally important that companies present information to customers in a manner informed by their customer research, and/or as a result of ongoing dialogue with customers that maintains their trust and confidence.

We expect the information companies provide their customers to clearly explain the components of their bills in a manner that the customer finds useful. We will keep under review how companies are presenting their bills, and may reflect lessons of best practice into our future charging rules if we were to consider that companies were not providing their customers with adequate information.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water sector in England and Wales provides customers with a good quality and efficient service at a fair price.



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