

Wholesale and retail charges – a consultation

About this document

In ‘[Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans](#)’ (the ‘final methodology statement’), we set out our approach to setting price controls for 2015-20.

In the past, we have set a single price control for water services, and a single price control for wastewater services. As we confirmed in the methodology statement, we will now be setting separate controls 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 on a more disaggregated basis than in the past, for each of these controls. Also, the UK Government’s Water Bill sets out changes to the governance arrangements of charges. If this legislation is passed, then we will no longer be required to ‘approve’ companies’ charges 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.

On 30 October 2013, the UK Government published a set of charging principles. These principles will underpin the development of the charging guidance that the UK Government will issue to Ofwat in the future. Our proposed approach to charging in this consultation is designed to be consistent with the UK Government’s published charging principles but may need to be adjusted pending final charging guidance from the UK and Welsh Governments.

This consultation describes some of the different options available for setting charging rules, and potential approaches to governance given our new price control framework and the Government’s reforms.

We will soon be setting price controls for the 2015-20 period. The way we set these controls will be very different to the way that they have been set in the past. This will have some impact on the process and form of charging schemes. New charges schemes will come into effect in April 2015. In order to do this sensibly and effectively, and to help companies plan the details of their new charges, we need to consult now – ahead of Government guidance.

We intend to set out our conclusions from this consultation in spring 2014, with a draft set of charging rules for consultation. These may need to be revised following consultation and final Government guidance.

Responses to this consultation will help to inform the approach we take to establishing charging rules, as well as how we progress a range of important charging issues for the next price review and beyond.

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Executive summary

The charges customers pay for the essential water and wastewater services they receive shape the relationship that they have with their water company and the choices they make about how they use those services.

On 30 October 2013, the UK Government published a set of charging principles. These principles will underpin the development of the charging guidance that the UK Government will issue to Ofwat in the future following the Water Bill. Our proposed approach to charging in this consultation is designed to be consistent with the UK Government's published charging principles but may need to be adjusted pending final charging guidance from the UK and Welsh Governments.

As the economic regulator for the water sector in England and Wales, we have a statutory duty to protect customers. We use a range of regulatory tools to do this, including setting limits on the total amount of revenue that companies can recover from customers every five years ('price limits').

Under the current arrangements, companies must propose their own charges which must be compliant with these price limits as well as other obligations that are imposed on them either by Parliament through the legislative framework, or through the licences they hold. Ofwat is then required under the law to 'approve' those charges. The other obligations include, for example, ensuring that there is no discrimination or preference shown to different groups of customers in the fixing of their charges and that charges do not prevent, restrict or distort competition. There are also provisions for companies to offer particular concessions in their tariff structures to certain groups of customers, subject to Government guidance.

Therefore, companies have choices about how they go about setting the charges that customers pay subject to some significant constraints arising from:

- legislation;
- the licences companies hold; and
- the price limits that we set.

In using our regulatory tools we act in accordance with strategic policy guidance from both the UK and Welsh Governments. The UK Government's Water Bill, which is currently passing through Parliament, sets out changes to the governance arrangements of charges. If this legislation is passed, then we will no longer be required to 'approve' companies' charges schemes; instead, we will set charging

rules with which companies will be required to comply. This new legislation will also seek to give business customers choice over the services that they receive, which also drives changes to the way charges are structured.

From 1 April 2015, in line with our new methodology for setting price controls, separate charges for ‘wholesale’ and ‘retail’ services will come into effect for all customers across England and Wales for the first time. The change will allow us to focus and tailor our regulatory scrutiny to reflect the underlying characteristics of companies improving transparency and helping us to encourage better outcomes for customers. For example, by setting a separate price limit around retail activities, including bad debt, we are able to focus management attention on these issues.

Setting separate wholesale and retail charges will require a different approach to the one that we have taken in the past.

This consultation describes some of the different options available for setting charging rules, and potential approaches to governance given our new price control framework and the Government’s reforms. This includes considering a variety of issues such as the following.

- **Different approaches to managing bill stability.** Customers consistently report that bill stability is a priority for them. Therefore, this is also a priority for us as a regulator, as well as being a policy priority for the Government. Companies are already incentivised to manage the stability of their bills and have a range of tools to do so. This consultation discusses whether explicit charging rules for stability of wholesale and household retail charges would also be appropriate.
- **Improving the cost reflectivity of charges.** At the highest level, cost reflectivity refers to prices reflecting the underlying costs of a given product or service (or combination of products and services). This consultation discusses the various ways that improved cost reflectivity could be pursued. It also seeks the views of companies and other interested stakeholders about the extent to which it would be appropriate, and how best to do this.

Reflecting the underlying costs through charges can incentivise efficient behaviour – and greater efficiency means lower bills to customers overall. Cost reflectivity can also deliver wider benefits to the environment. Consequently, as our regulatory duties include protecting customers and contributing to the achievement of sustainable development, we must consider carefully the different options for improving the cost reflectivity of

charges. There will be tensions between this objective and maintaining bill stability that we will need to manage carefully, having regard to the guidance from the Government, in both the short and long term. For example, if we move to charges that are significantly more cost reflective tomorrow, bill stability would most likely be threatened.

- **Standardising wholesale charges.** While the level of charges will vary across companies – reflecting differences in their underlying costs and local circumstances – there may be merit in requiring them to use a common methodology in deriving their wholesale charges. This would make charging structures across England and Wales more consistent. It would also ensure that retailers providing services to business customers that are able to choose their retailer are not faced with such a significant range of very different wholesale charging schemes in different regions – for example, when serving customers with sites in different regions across England and Wales. This consultation discusses the potential trade-offs around standardisation, and the different potential ways that it could be pursued.
- **Information and governance.** We are consulting on our preferred approach to assess compliance of wholesale and household retail charges with price limits and companies' other obligations. We want to do this in a way that ensures companies take ownership of their own charges and engage with their customers. To this end, we also propose to no longer publish charges on the behalf of companies. Retail charges for business customers, or 'default tariffs' for customers that will be able to choose their supplier, will be set formally through the price control mechanism.
- **Splitting of wholesale and retail charges.** This will be the first time that companies will be required to split their wholesale and retail charges. We welcome views from respondents on how companies could do this. In publishing the conclusions of this consultation, we may choose to summarise the various approaches, providing our views on the benefits and pitfalls of any approaches provided.

We will soon be setting price controls for the 2015-20 period. The way we set these controls will be very different to the way that they have been set in the past. This will likely have some impact on the process and form of charging schemes. New charges schemes will come into effect in April 2015. In order to do this sensibly and effectively, and to help companies plan the details of their new charges, we need to consult now – ahead of Government guidance.

We intend to set out our conclusions from this consultation in spring 2014, with a draft set of charging rules for consultation. These may need to be revised following consultation and final Government guidance.

Responses to this consultation will help to inform the approach we take to establishing charging rules, as well as how we progress a range of important charging issues for the next price review and beyond.

Consultation questions

Throughout this consultation, we raise a number of specific questions, which we have summarised here. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues we raise in this document.

Q1 Do you agree that we should set rules for bill stability, for charges for non-contestable services?

Q2 Do you agree with our initial preference for companies to carry out a proportionate impact assessment and develop a strategy for handling any incidence effects of significant changes to charges, rather than be more prescriptive?

Q3 How material are the incidence effects likely to be if we were to set specific requirements for cost reflectivity?

Q4 Would it be appropriate for us to prioritise cost reflectivity in certain areas?

Q5 Do you agree with our preference for initially setting high-level requirements for cost reflectivity?

Q6 Do you have views on any specific rules we should set to promote cost reflectivity?

Q7 How material are the incidence effects likely to be for different types of standardisation?

Q8 Do you agree with our preference for some level of standardisation of the methodologies that companies use to derive wholesale charges, but for us not to design and specify companies' tariffs?

Q9 Would it be appropriate for us to prioritise standardisation for certain charges? If so, which ones and why?

Q10 Do you have any views on what specific rules we should set to promote standardised charging methodologies?

Q11 Do you agree with our preferred option of assessing wholesale price limit compliance through the regulatory accounts?

Q12 What would be a suitable data set to support an assurance that charges have no undue preference or discrimination?

Q13 Do you agree that the same governance process for assessing wholesale charges can be applied to household retail charges?

Q14 Do you agree with our preferred option of including considerations of non-household retail charging governance into the annual risk and compliance statements (RCSs), and to check any charges levied by agreement?

Q15 Do you agree with our preferred option of no longer publishing charges on behalf of companies?

Responding to this consultation

We welcome your responses to this consultation by **7 March 2014**.

You can email your responses to price.review@ofwat.gsi.gov.uk or post them to:

Wholesale and retail charges consultation
Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. The Water Bill

In June 2013, the UK Government published its Water Bill. The Water Bill sets out a suite of reforms aimed at achieving the vision set out in the Water White Paper: for future water management in which the water sector is resilient, in which companies are more efficient and customer focused, and in which water is valued as the precious resource it is.

The legislative changes set out in the Water Bill will harness market forces to enable:

- all non-household customers in England to choose their water and wastewater service supplier; and
- the wholesale trading of water between appointed companies and new entrants, promoting the efficient use of scarce water resources, and improvements in the resilience of services for customers.

The UK Government estimates that these reforms will deliver in the region of £2 billion of benefits to customers and the environment.

Charges schemes will remain legal obligations on companies. However, the Water Bill also proposes changes to the way Ofwat oversees companies' charges schemes, as well as other ('upstream') charging elements such as:

- access pricing;
- bulk supplies; and
- new connections.

While these upstream elements of the Government's reforms – and the charging rules associated with them – will be of critical importance in delivering the Government's vision, we are not consulting on them at this time. In November 2013, we published two high-level discussion documents requesting stakeholder feedback to inform our emerging thinking on the areas of access pricing and charging for new connections, and will consult in more detail after the Water Bill has received Royal Assent.

We will soon be setting price controls for the 2015-20 period. The way we set these controls will be very different to the way that they have been set in the past. In particular, we will be setting separate price controls for wholesale and retail services, and each price control will need to be accompanied by a scheme of charges, with different charges for:

- wholesale services;
- household retail services – where customers will still have these services provided to them by their local monopoly supplier; and
- non-household retail services – where customers in England will, following further legislation, be eligible to choose their retail supplier.

This will have some impact on the process and form of charging schemes. New charges schemes will come into effect in April 2015. In order to do this sensibly and effectively, and to help companies plan the details of their new charges, we need to consult now – ahead of Government guidance. We intend to set out our conclusions from this consultation in spring 2014, with a draft set of charging rules for consultation. We will need to keep these rules under review and they may need to be revised following consultation and final Government guidance.

The Secretary of State and Welsh Ministers are currently in the process of producing charging guidance, to which we will have regard in developing the future rules we set.

This consultation discusses potential options for charging rules, considered within the following context.

- **Relevant legislation**, including the Water Industry Act 1991 (WIA91) and the forthcoming Water Act in particular.
- **Relevant guidance** from both the UK and Welsh Governments, including:
 - the UK Government’s Strategic Policy Statement;
 - the Welsh Government’s Strategic Environmental Assessment consultation and social tariff guidance;
 - the UK Government’s social tariff guidance, guidance on concessionary schemes for community groups for surface water drainage charges, and previous charges schemes guidance; and
 - the UK Government’s recently published charging principles.

If the Government’s new charging guidance materially changes the policy context from the positions set out above, then we will need to have regard to it, and if appropriate, revise our proposed approach accordingly. However, given the critical need to develop our approach to charges schemes to enable the new retail and wholesale price controls and their associated charges to be set, and the policy framework issued by Government, we consider it appropriate to consult now on our approach to companies’ charges schemes.

The UK Government has stated that its charging principles (see text box below) will underpin the development of the charging guidance that it will issue to Ofwat in setting future charging rules.

The UK Government's charging principles

1. Household customers must continue to be protected through the price control process. They will not subsidise the development of competitive markets for business customers.
2. Charges will need to evolve over time, and any transition to an improved reflection of resource costs in the competitive part of the market must be delivered in a measured way and regulated to ensure that all customers face predictable and stable charges.
3. No category of customer should be unfairly disadvantaged by the way reform impacts on water charges. A fair and non-discriminatory approach to sharing network costs will be critical. For example, rural customers must continue to be protected.
4. The charging regime must support delivery of the Government's approach to investment in water and sewerage services, ensuring an attractive environment for investors and minimising any risk that water and sewerage companies would be unable to recover the costs of efficient investment.
5. The charging regime must enable new entrants to compete on level terms with incumbent companies.
6. The charging regime must ensure that the implementation of the market reforms set out in the Water Bill complements environmental protections. The evolution towards more cost-reflective pricing of water resources in the competitive part of the market will help to drive innovation and improve recognition of environmental costs.

We have considered these principles in developing this consultation, and will have regard to any further guidance issued by the UK and Welsh Governments.

A number of the principles are already supported through various areas of our regulatory framework. For example:

- we have put in place separate price controls, which will ensure that household customers will continue to be protected (principle 1), and will use default tariffs to ensure that non-household customers are protected while not impeding the benefits of the market. In scrutinising companies' business plans, we will test whether companies have allocated any costs associated with the competitive markets for business customers to their household controls, and will challenge where appropriate;

- in setting price controls we have allocated companies' regulatory capital values (RCVs) to wholesale controls, and will continue to use a weighted average cost of capital approach with prices being linked to inflation for the asset-intensive wholesale controls. This will help ensure an attractive environment to investors (principle 4); and
- in September 2013, we published a [discussion document on a level playing field](#). This covers some of the key considerations for ensuring a level playing field between new entrants and incumbent companies (principle 5). We discuss further questions relating to charging standardisation within this consultation.

Principles 2, 3, and 6 relate to the cost reflectivity and evolutionary nature of charges. We discuss these issues in detail in chapters 3 and 4.

Although the Welsh Government has not published any charging principles, as stated above, we have considered previous charging guidance and policy statements in developing this consultation, and will have full regard to any further guidance that it issues.

2. Existing duties and obligations

In setting charges companies already have a series of duties and obligations with which they must comply. These include (but are not limited to) the following.

- **Licence condition B.** Companies are required to make sure that their charges comply with their price limits.
- **Licence condition E.** Companies are required to make sure that there is no undue discrimination against, or preference shown to any class of customers or potential customers.
- **Social tariffs and surface water drainage concessions.** As provided for by the Flood and Water Management Act 2010, water companies may include a provision in their charges schemes designed to reduce charges to individuals who would have difficulty paying their charges in full. Companies may also include a provision in their charges schemes designed to reduce charges to community groups in respect of surface water drainage from their property, where the charge is based on the surface area drained.

In including any such provision within their charges schemes, companies must have regard to any guidance issued by the Secretary of State in England and the Welsh Government in Wales.

- **Competition Act 1998 (CA98).** Chapter I of the CA98 prohibits agreements that prevent, restrict or distort competition. Chapter II prohibits the abuse of a dominant position¹. Where anti-competitive agreements or conduct are reasonably suspected, Ofwat has concurrent power to investigate and take appropriate enforcement action.

¹ To the extent that the agreement or conduct may affect trade between member states, these prohibitions are contained in Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU).

3. Keeping bills stable for customers

3.1 Context

One of the UK Government’s charging principles is that:

“Charges will need to evolve over time, and any transition to an improved reflection of resource costs in the competitive part of the market must be delivered in a measured way and regulated to ensure that all customers face predictable and stable charges.”

This places a particular emphasis on bill stability, predictability and ‘evolutionary’ changes over time.

Customer research² carried out at the 2009 price review found that 81% of customers would prefer that “bills change steadily every year throughout the period, so that customers do not see big changes from year to year”. So bill stability is clearly a key issue, and will need to be managed carefully in transitions to any new approaches to charging.

This chapter discusses the existing framework in which companies manage the stability of bills, and potential options for future rules covering stability.

3.2 The existing framework

Companies are already incentivised through the price control to deliver good customer service – for example, through the service incentive mechanism (SIM) and potentially other outcome delivery incentives – and hence (to some degree) to manage bill stability. Indeed, even without these explicit incentives, there are also strong reputational incentives on companies to manage the stability of their customers’ bills.

² MVA Consulting report for Ofwat, Defra, Welsh Assembly Government, CCWater, Environment Agency, DWI, Natural England and Water UK (2009) – Understanding customers’ views http://www.ofwat.gov.uk/pricereview/pr09phase3/pap_rsh_pr09quantrshsumm.pdf

Our new price control methodology gives companies greater scope than ever before to manage bill stability issues. Companies have been able to propose their own run-off rates (or depreciation charges) and the proportion of expenditure treated as ‘pay as you go’ (PAYG) relative to the amount being added to their RCV. This effectively allows companies to flex their price limit proposals and charges to customers across price control periods balancing the burden of any new expenditure between current and future customers.

Artificially imposing bill stability restrictions may limit the extent to which charges can be cost reflective in the short run. However, one of the UK Government’s charging principles focuses on managing bill stability and one of our existing charging principles requires companies to develop strategies to handle the effect of changing tariff design on customers’ bills.

3.3 Rules for bill stability

If it were desirable to set rules for bill stability, such rules could either be in the form of high-level principles, or more specific requirements. For example, rules could take the form of requiring companies to:

- a) carry out a proportionate impact assessment and develop a strategy for handling any incidence effects of significant changes to charges;
- b) follow the above rule, but also comply with specific requirements that Ofwat sets for such strategies (such as the level of engagement with customers, and considering a range of mitigation techniques);
- c) use glide-paths to transition to new arrangements for wholesale and household retail charges; or
- d) follow the above rule, but also comply with specific requirements that Ofwat sets for how such glide-paths should be applied (for example, for glide-paths to be designed following customer engagement, but not to be spread over a number of years beyond a certain limit, so that the benefits of efficient price signals are not delayed too far into the future).

Our current preference is **option (a)** – that is, to reflect broadly our existing charging principle on bill stability which requires companies to carry out a proportionate impact assessment and develop a strategy for handling any incidence effects associated with significant changes to their methodologies or the introduction of new tariffs.

Companies are able to manage affordability issues (to an extent) through the increased flexibility the new price control methodology gives them. We are not currently convinced that it would be beneficial for us to set rules specifying the use of glide-paths.

It may be appropriate to set different charging rules for different charging areas. The majority of charges will remain non-contestable and all household customers will continue to receive retail services only from their local incumbent. Even with the contestable non-households, the majority of a customer's bill will comprise the non-contestable wholesale charge. We have put in place clear regulatory and accounting barriers to keep household and non-household costs separate. Household customers will be protected from any costs associated with retail competition.

For contestable services, competition will place a downward pressure on bills, and we will use default tariffs to protect customers until the market is operating effectively. Default tariffs will act as a 'backstop', giving companies' flexibility to offer their customers new tariffs and service offerings.

Setting stability restrictions for contestable charges could risk impeding the development of the competitive market, and could create tensions with competition law. Consequently, we do not consider it appropriate to set additional restrictions for contestable charges.

3.4 Consultation questions

Q1 Do you agree that we should set rules for bill stability, for charges for non-contestable services?

Q2 Do you agree with our initial preference for companies to carry out a proportionate impact assessment and develop a strategy for handling any incidence effects of significant changes to charges, rather than be more prescriptive?

4. Evolving charges over time to improve their cost reflectivity where this will benefit customers

4.1 Context

Three of the UK Government’s charging principles are that:

“Charges will need to evolve over time, but any transition to an improved reflection of resource costs in the competitive part of the market must be delivered in a measured way and regulated to ensure that all customers face predictable and stable charges”;

“No category of customer should be unfairly disadvantaged by the way reform impacts on water charges. A fair and non-discriminatory approach to sharing network costs will be critical. For example, rural customers must continue to be protected”; and

“The charging regime must ensure that the implementation of the market reforms set out in the Water Bill complements environmental protections. The evolution towards more cost-reflective pricing of water resources in the competitive part of the market will help to drive innovation and improve recognition of environmental costs.”

This chapter discusses some of the ways that it may be beneficial for charges to evolve over time, including through greater cost reflectivity where this will deliver clear benefits to customers and/or the environment.

Moving to greater cost reflectivity could be in conflict with maintaining bill stability and there is a balance to be struck between these two competing objectives. There may also be benefits of focusing on improving cost reflectivity for particular charges (for example, for wholesale charges).

4.1.1 What do we mean by cost reflectivity?

At the highest level, cost reflectivity refers to prices reflecting the underlying costs of a given product or service (or combination of products and services).

There are a number of different elements of cost reflectivity. For example, cost reflectivity could comprise the following considerations.

- **The drivers of costs.** Currently, there are a limited number of cost drivers reflected in companies' charges schemes. For example, the majority of the companies do not calculate their surface water drainage charges by using an area-based component, which is likely to be the key cost driver.

Example of improved cost reflectivity

In 2003 we reviewed how non-household customers are charged for surface water drainage. We recommended that charges should more closely reflect how much surface water drains off a property so that customers broadly pay for the service they receive.

Some companies have adopted an area-based component within their surface water drainage charges schemes. This more closely reflects the costs customers place on the system, as sites with large non-permeable areas cause greater levels of rainwater to drain into the system.

Customers can reduce their charges by making surfaces more permeable (for example, replacing asphalt with gravel), or installing soakaways. This reduces the volume of rainwater flowing into sewers, and consequently the costs that the company incurs. This leads to lower bills to customers overall, and puts more water back into the environment. It may also delay or avoid the need for significant new capital schemes which could be expensive for customers and harmful for the environment.

Companies can offer rebates for community groups under certain circumstances, and also have a range of other tools to manage changes to their approach to charging (as discussed above).

In Germany, adopting transparent surface water drainage charges and subsidies has led to a high amount of retrofitting of sustainable drainage systems (SUDS), particularly green roofs and water reuse systems. In North-Rhine Westphalia, approximately six million square metres of surface area was disconnected from the sewer between 1996 and 2004³.

Other cost drivers could be included to reflect the type of treatment technology, pumping costs, and the time of year when water is used (for example, seasonal tariffs).

³ See:

http://webarchive.nationalarchives.gov.uk/20100807034701/http://archive.cabinetoffice.gov.uk/pittreview/_media/assets/www.cabinetoffice.gov.uk/flooding_review/pitt_review_full%20pdf.pdf

- **The structure of costs.** Efficiency is often increased when price structures reflect cost structures. In the short run, water companies have high ‘fixed’ costs and low ‘variable’ costs. Currently, water charges (that are based on meter readings) have a higher variable component and a lower fixed component (standing charge) than those implied by the short-run cost structures.

This is not necessarily a bad thing. A higher variable component results in stronger price signals being sent around reducing consumption, and arguably could more closely reflect the longer-run cost structures of the sector. It could also reflect the fact that there are social and environmental costs incurred in the consumption of water. But there are currently no clear linkages between the existing tariff structures and projections around the longer-term drivers of costs.

Other regulated sectors (for example, telecoms) use long run incremental cost (LRIC) models to inform regulated price structures so that efficient price signals can be sent.

- **The geographic nature of costs.** Currently, the prices in charges schemes reflect a company’s aggregated costs across the whole of its geographic area – that is, price signals do not reveal any non-uniform costs across a company’s area. For example, some companies’ areas comprise a number of water resource zones (WRZs), some of which are in surplus while others require significant future investment to meet projected demand, implying differences in relevant incremental costs to meet demand.

With the current level of geographic cost aggregation reflected in charges schemes, there is minimal incentive for water-intensive industries to choose to locate away from areas where water is scarce. Increasing demand in water scarce areas can not only have negative environmental effects, but can lead to higher costs for water customers, as additional supply solutions are required.

4.1.2 Why cost reflectivity?

At an aggregate level, the total revenue that we allow companies to recover through the charges that they levy on customers is linked closely to their underlying costs. However, there is considerable scope to improve the extent over time to which the specific charges levied on individual households and businesses reflect the costs incurred in serving those customers.

Cost reflectivity promotes efficiency when parties pay for the costs they create and greater efficiency means lower bills to customers overall. It can also improve transparency around environmental trade-offs. And it can help to reveal costs, which in turn can facilitate the efficient management of companies.

This aligns to our objectives of protecting current and future consumers, promoting efficiency, and contributing to the achievement of sustainable development.

Example of improved cost reflectivity

Cost reflectivity improves the transparency of costs. If companies were to set out clearly the costs of water in different areas, and how costs translate into bills, informed decisions could be made as to whether there was customer support for abstraction to take place from more expensive water sources to offset over-abstraction in water scarce areas. At the moment, heavily-averaged tariffs provide little in the way of transparency.

But, moves to increase cost reflectivity could lead to some level of incidence effects on customers' bills. While the UK Government's charging principles recognise that "charges will need to evolve over time", they also emphasise that all customers should face "predictable and stable charges" and the need to protect the position of customers, such as those in rural areas, who may prove more expensive to serve.

The scale of any incidence effects on customer bills may limit the scope for some changes to increase cost reflectivity of charges and it is unlikely to be beneficial in all instances. However, the size of the potential incidence effects depends (in part) on the degree of cost reflectivity that is sought. If it were thought that the incidence effects were likely to be large, but a move towards greater cost reflectivity was still considered to be a beneficial objective, then it would be possible to phase any potential changes over the long term using very progressive glide-paths rather than making a step change in the level of charges (as discussed above).

Hence, the existence of incidence effects does not in itself have to foreclose the pursuit of cost reflectivity in all areas. If the incidence effect on bills were severe, then it might not be sensible to pursue cost reflectivity; but if not, it may still be possible to take forward changes – only more gradually and over a much longer timescale. Action may also need to be taken to offset adverse impacts on particular customer groups or geographic areas.

Similarly, it will be important to consider the extent of any distributional effects on particular customer groups of a move to more cost reflective charges. For example, we must have regard to the interest of:

- a) individuals who are disabled or chronically sick;
- b) individuals of pensionable age;
- c) individuals with low incomes;
- d) individuals residing in rural areas; and
- e) customers, of companies holding an appointment under Chapter 1 of Part 2 of the WIA91, whose premises are not eligible to be supplied by a licensed water supplier.

In certain circumstances and for some charges, economic regulators often pursue cost reflectivity as a way of delivering benefits for customers and the environment. For example, Ofgem has placed cost reflectivity as a requirement into companies' licences, and one of the ORR's key charging objectives is for charges to reflect the efficient costs caused as a result of using the infrastructure. It should be noted that both of these relate to wholesale charges, and as stated above, there may need to be different approaches used in setting wholesale and retail charges, and a desire for different emphasis.

Comparisons between the water and energy sectors can often be drawn. It should also be noted that the pursuit of improved cost reflectivity in energy has been delivered in a progressive manner, with many of the end retail charges remaining heavily averaged.

4.2 Rules for cost reflectivity

4.2.1 Are there any aspects of cost reflectivity we should prioritise?

In setting rules it may be appropriate to prioritise certain types of cost reflectivity. The vision of the Water White Paper explicitly references water being valued as the precious resource it is, and the Welsh Government's Strategic Environmental Assessment consultation states that we need to value water more, and understand the spatial variations of water resources. The UK Government's charging principles explicitly reference an improved reflection of resource costs in the competitive parts of the market. While these objectives are different, there is a common theme of valuing water as a resource.

If it were desirable to initially prioritise a particular type of cost reflectivity, focusing on reflecting the costs of water resources in charges schemes may appear to align more closely to the UK Government's policy agenda, as opposed to reflecting regional differences in network costs, for example.

Alternatively, focusing on making sure that the drivers of costs are appropriately reflected in charges schemes could potentially maximise efficient behaviour by end customers (for example, reflecting the costs of surface water run-off may have limited effect on customer behaviour if their charges do not contain an area-based component, as their behaviour would have limited direct effect on the charges they face).

The lack of significant meter penetration is likely to be a key restraint on the extent that certain drivers of costs can be reflected in customers' charges. However, it should be noted that the level of metering is progressively increasing over time, and already a substantial proportion (about 50%) of customers have a water meter (more than 90% of business customers).

4.2.2 What type of rules could we set?

In setting rules we could either set high-level requirements (giving companies a large degree of flexibility in producing their charging schemes), or we could set more detailed rules (requiring cost reflectivity in specific ways).

High-level requirements would provide companies with greater flexibility in developing their charges. However, they may be less enforceable as they are less specific in nature.

Our current preference is to set rules in the form of general high-level requirements. It may be appropriate to make rules more detailed over time, following any lessons we learn from continuing to give companies a high degree of flexibility in setting their charges.

It may be appropriate not to set specific rules on charges in the contestable market (beyond the use of default tariffs). This is because doing so could risk creating an inadvertent conflict with competition law. It should be noted that this is a relatively small part of customers' overall bills, with approximately 90% of bill values being made up by wholesale services.

4.3 Consultation questions

Q3 How material are the incidence effects likely to be if we were to set specific requirements for cost reflectivity?

Q4 Would it be appropriate for us to prioritise cost reflectivity in certain areas?

Q5 Do you agree with our preference for initially setting high-level requirements for cost reflectivity?

Q6 Do you have views on any specific rules we should set to promote cost reflectivity?

5. Standardising wholesale charges

5.1 Context

One of the UK Government's charging principles is that:

“The charging regime must enable new entrants to compete on level terms with incumbent companies.”

While this principle covers a range of issues (many which are outside the scope of this consultation), the extent to which wholesale charges are standardised could help reduce complexity in the non-household retail market. For example, a new retailer seeking to enter the market and provide greater choice to non-household customers in England might find understanding a wide range of alternative wholesale tariff structures across all the different regional water companies a significant barrier to entry. If these tariff structures could be standardised to some degree over some time frame, then this could improve levels of market entry and choice, delivering greater benefits for customers.

Standardisation in this context should not imply a single set of wholesale charges across the country. Charging levels will always differ across companies, reflecting differences in their underlying costs and their local geographic circumstances. However, there may be benefits in moving towards a common methodology in deriving wholesale charges, including standardising particular services and activities as 'wholesale' or 'retail' services and the methods for deriving the charges. This is so that retailers operating in the competitive non-household market are not faced with very different wholesale charges schemes in different regions where wholesale services are required to serve relevant retail markets.

There are different types of standardisation.

- Standard use of terms and language used in charges schemes.
- Standard charging structures – for example, banded or two-part tariffs.
- Standard cost allocation – the method used to allocate costs to different tariff components.
- Standard charging levels – some ancillary services may cost the same, however, the majority of charges will differ across companies, reflecting differences in their underlying costs and their local geographic circumstances.

In response to our price control methodology consultation, Gemserv stated that:

“Given [their] experience of competition roll-out in other markets, the charging structures need to be consistently designed and delivered at least one year in advance of market opening to facilitate market competition, in other words delivery in 2016 for 2017.”

Similarly, a number of potential entrants to the sector have expressed a desire for more standardised wholesale charging structures. In the energy industry, it took a number of years for companies to move to standardised methodologies. Having standardised wholesale charges from ‘day one’ could be the most effective way of delivering standardisation, and could simplify the role of the market operator significantly.

While standardised structures could improve transparency, and therefore the effectiveness of the emerging retail market – leading to benefits for customers – standardisation could limit the extent to which companies would be able to customise their charges to reflect specific attributes of their business (that is, develop innovative tariffs), and would likely lead to some level of incidence effects on customers’ bills depending on how it was implemented.

Therefore, there are costs and benefits of pursuing greater standardisation of wholesale charging structures, and we would need to consider the most proportionate and effective approach.

5.2 Rules for standardisation

One option could be not to pursue standardisation. This would avoid the risk of reducing tariff customisation (innovation), and creating incidence effects as a result of standardisation.

Alternatively, moving towards increased standardisation could take a number of different forms. We could set rules that would require companies to:

- a) follow a set of high-level methodological principles in developing their charges;
- b) move progressively towards standardised methodologies – for example, as developed by a forum involving Ofwat, new entrant retailers, and current companies; or
- c) comply with tariff designs as specified by Ofwat.

There may be certain products and services where it would be appropriate to standardise relevant methodologies, while companies could set other charging components on an individual basis.

Work is ongoing within the [Open Water programme](#) to develop a granular view of the potential products and services that companies could offer within the new market.

There could be benefits of consistency if the industry were to adopt Scottish Water's charging methodologies (its different charges are shown in appendix 1). However, Scottish Water's methodologies may differ from those that companies in England and Wales adopt and, indeed, may not be appropriate given the range of differences in the market and supply conditions.

Our current preference is for some level of standardised wholesale charge methodologies over time, but for us not to design and specify companies' tariffs.

5.3 Consultation questions

Q7 How material are the incidence effects likely to be for different types of standardisation?

Q8 Do you agree with our preference for some level of standardisation of the methodologies that the companies use to derive wholesale charges, but for us not to design and specify companies' tariffs?

Q9 Would it be appropriate for us to prioritise standardisation for certain charges? If so, which ones and why?

Q10 Do you have any views on what specific rules we should set to promote standardised charging methodologies?

6. Information and governance

6.1 Context

The WIA91 gives water and sewerage companies (WaSCs) and water only companies (WoCs) in England and Wales the power to fix charges for the services they provide. The companies have discretion in how they develop those charges. With a few exceptions, each company has to set out its charges in a charges scheme. The companies cannot bill customers in accordance with this charges scheme until we have approved it. The Water Bill currently passing through Parliament contains a provision that would repeal this approval power and replace it with a power to introduce charging rules, including for companies' charges schemes.

In seeking to move to a new approach in this area it is important that we find a set of arrangements that are both effective and proportionate.

6.1.1 Charges schemes

The charges scheme is a statement of each company's charges to customers and the policies it applies to them. It has to cover all standard charges, including all household charges. The WIA91 currently requires each company to produce a new scheme each year for us to approve.

6.1.2 Statement of assurance

So that we can approve a company's charges scheme, we currently require it to submit to us a statement of assurance on its final charges scheme. The statement should contain the following provisions.

- a) A statement that the company complies with its legal obligations relating to customer charges.
- b) A statement that the company's charges are consistent with Ofwat's charging principles.
- c) An explanation of any new charges or changes to the tariff structure and how these relate to Ofwat's principles and guidelines.

- d) A statement that the company has appropriate systems and processes in place to make sure that the data and information contained in the charges scheme, principal statement and additional information are accurate.
- e) A statement that the company has consulted the Consumer Council for Water (CCWater) in a timely and effective manner on changes to the charges scheme.

Where the company has a long-term strategy for dealing with known charging issues, it should also explain in its assurance statement the issues and its strategy for attaining compliance with the principles.

The assurance statement should be signed by the company's Board or a Director of the company, delegated by its Board.

6.1.3 The principal statement

This is a statement from the company showing whether or not its proposed charges meet the price limits we set. The architecture of such a statement is designed to yield the weighted average charges increase (WACI) for comparison with the WACI set as the price limit. It is supported by data, including:

- customer charges;
- customer property numbers;
- customer types;
- revenues; and
- water and sewage volumes.

6.1.4 Charging principles and guidelines

Our current principles set out the minimum information, checks and policies that we require the companies to confirm they have in place, as evidence that they have complied with their duties and obligations. The guidelines give more detail about how the companies' charges could fit with the principles. Under the WIA91, companies are free to develop their own charging methodologies and policies, as long as they can demonstrate that the resulting charges are transparent and consistent with the principles.

6.1.5 The process

The current formal process starts in the autumn. We publish an information notice setting out the timetable for the year's charging approval process. We also confirm any changes to our charging principles and guidelines at that time. At about the same time, we also send a template principal statement to the companies. They then develop their charges, taking into account the price limits we have set for the charging year and the November Retail Price Index (RPI) figures, published in mid-December. They submit their assurance statement and the completed principal statement in early January.

Condition B of the companies' licences requires them to provide an auditor's assurance to us about the information they have submitted in the principal statement. We expect companies to send some additional information alongside the principal statement, particularly regarding the balance between metered and unmetered charges for household customers and average household bill levels.

We currently check each company's assurance statement and its principal statement. This is to ensure that a company will not exceed its price limit. We also do this to make sure that charges do not show undue preference to or discriminate against any group of customers. If we are satisfied that the charges scheme meets all the relevant criteria, we approve it. The company can then begin to bill its customers.

As soon as we have approved these charges schemes, the new appointments and variations (NAVs) submit their assurance statements. NAVs are small companies that have replaced the appointed WaSC and/or WoC for a specific geographic area. Their terms of appointment require them to leave customers 'no worse off' than the charges of the main local appointed WaSC and/or WoC. We also approve these charges schemes.

6.1.6 Licence condition changes

Condition B of company licences provides our principal governance mechanisms for charges. From April 2015, we have removed the requirement on companies in condition B to prepare an annual principal statement (and an auditor's report) to demonstrate compliance with the price control we set. Instead, we have inserted provisions in the modified licence to allow us to specify at each determination the way that companies will do so in the future. We consider that a more targeted and proportionate approach to the information that we ask companies to provide is consistent with focused and smarter regulation.

The revised licence condition B alters but retains definitions of standard and excluded charges. The new wording includes a list of excluded charges – meaning that these charges, and the revenue generated from them, are excluded from the wholesale and retail price controls.

The revised condition B also provides that we may require companies to publish wholesale charges. This requirement is to be made by way of a notice from us specifying the:

- information that the company is to provide;
- method of publication;
- time by which publication is required (being a reasonable period of time); and
- period for which the published charges are to be effective.

6.2 Wholesale charges

In [IN 13/04, 'Empowering water and sewerage customers through information'](#), we outlined a number of principles for customer information, one of which was transparency.

The market may operate more effectively if all the participants are able to see the charges and the basis for them. For example, a lack of publicly available information may not build confidence that all retailers are being treated equally in the market and that there is a level playing field. In deciding how to regulate wholesale charges we need to ensure that our approach is effective for customers. Similarly, we need to ensure that our approach imposes a proportionate burden on companies.

In light of these two considerations, we intend to require companies to publish their wholesale charges, as provided for in licence condition B.

However, publishing the wholesale charges scheme by itself is not sufficient to show compliance with the wholesale price limits.

6.2.1 Options for regulating wholesale price limit compliance

One option would be to assess charges based on likely customer numbers and demand to see whether the projected revenue was likely to exceed the price limit. To make this assessment, we would need a tool like the current principal statement but which collated that information in a form which showed the anticipated revenue from wholesale charges.

This exercise would not provide a guarantee that the wholesale price limit would not be exceeded, as the level of revenue is not determined purely by the level of charges, but also by levels of demand and changes in the number of customers.

Another approach would be to assess compliance with the price limit after the fact – that is, after the end of the charging year. The most obvious vehicle for doing this would be the companies' regulatory accounts, which are submitted on 15 July each year covering the previous year's accounts.

Using the regulatory accounts is the least burdensome approach, as this exercise is already conducted and the incremental burden from ensuring that wholesale price limit compliance was demonstrated in the revenue figures would be very small. It could be argued that this would be a proportionate approach since the annual adjustments and the revenue correction mechanism (RCM) built into our price control process would ensure that customers got their money back if charges proved to be too high.

Our current preference is to assess compliance through the regulatory accounts, and require subsequent 'true-ups' where allowed revenue and revenue collected varies. We consider that this approach would be effective and would also impose a proportionate burden on companies.

6.2.2 Options for regulating other aspects of wholesale charges

Issues such as undue preference or discrimination can be dealt with throughout the year as they arise, and as new tariffs are in a development phase. There are a number of options for addressing these kinds of issues.

One approach would be to respond to complaints as they are made throughout the year, along with any other market intelligence, and to address issues with charges as intelligence becomes available on a risk-based approach. Complaints about charges are often made to CCWater, and we would expect it to continue to be a primary source of intelligence. We would expect to act in this reactive and vigilant mode whichever option is chosen.

Alternatively, an approach that moves beyond the purely reactive would be to include considerations of charges governance into the companies' annual risk and compliance statements (RCSs). It would be consistent with the remainder of the RCSs to ask companies about their compliance with legal obligations on charging. The RCSs are published alongside performance data that supports the statements made in the RCSs. We could consider publishing some key metrics for charging in a similar way.

Another option would be to ask for an assurance statement before charges come into effect, assuring us (and customers) that the company's charges comply with the charging rules and the requirement for no undue preference or discrimination. This option is close to our existing practice for the charges we approve.

Finally, we could check all of a company's wholesale charges before they come into effect and seek assurance that companies are satisfied that there are no problems.

Our current preference is to include considerations of charges governance into the companies' annual RCSs. We think that this would be the most sensible approach, balancing proportionality and effectiveness. This also aligns to our approach of placing the accountability for compliance firmly with companies, and would also be consistent with the purpose of the RCSs.

6.2.3 Consultation questions

Q11 Do you agree with our preferred option of assessing wholesale price limit compliance through the regulatory accounts?

Q12 What would be a suitable data set to support an assurance that charges have no undue preference or discrimination?

6.3 Household retail charges

6.3.1 Options for regulating household retail charges

The same considerations apply to household retail charges as wholesale charges. Therefore, we propose that the same process applies.

6.3.2 Consultation questions

Q13 Do you agree that the same governance process for assessing wholesale charges can be applied to household retail charges?

6.4 Non-household retail charges

6.4.1 Options for regulating non-household retail charges

It is critical that our approach to regulating charges is effective at protecting customers. Non-household customers in England will be protected through effective competition and choice, so it is important that our approach to regulating those charges does not damage the development of competition. Indeed, as competition develops the most effective approach may be to roll back regulation of charges entirely, which would also reduce the regulatory burden on companies.

We will set out the default tariffs for incumbent companies in our PR14 final determinations, which will provide the principal control for non-household charges. We may wish to consider further checks and balances to ensure that customers are being correctly charged and are able to understand their charges.

One option would be to respond to complaints and to ask for assurance in the RCS that compliant default tariffs are being offered.

This option could be supplemented by checking that charges levied by agreement (that is, not under a charges scheme) are not levied in a manner that amounts to an abuse of a dominant position.

A further option would be to check all non-household retail charges before they come into effect and seek assurance that companies are satisfied that there are no problems.

Our current preference is to respond to complaints and ask for assurance in the RCSs, and to check any charges levied by agreement. This would be consistent with our approach to wholesale tariffs, and we consider that it would be effective in protecting customers while also minimising the regulatory burden on companies.

6.4.2 Consultation questions

Q14 Do you agree with our preferred option of including considerations of non-household retail charging governance into the annual risk and compliance statements (RCSs), and to check any charges levied by agreement?

6.5 Further information provision and timing considerations

6.5.1 Communicating bill increases to customers

A key principle of our approach to regulation is to give companies clear ownership and accountability of the relationship with their customers. Therefore, maintaining the existing approach of us publishing average charges on the behalf of companies would not appear to be a consistent position.

So, our current preference is to move away from us publishing charges on behalf of companies, and for the ownership of communicating charges to customers to sit solely and clearly with the companies.

This includes companies being responsible for informing NAVs in their area of their charges ahead of the new charging year to give the NAVs sufficient time to take them into account in their own charges schemes.

6.5.2 Interaction of charging with PR14 final determinations

There may be a relatively short period of time from companies receiving their final determinations to when they need to produce their final charges schemes.

While it is for companies to make sure that they are able to comply with their obligations of producing compliant charges schemes, we would expect them to develop models that would enable their charges to be easily (and relatively mechanistically) updated from the draft determination revenue levels once the final determinations are issued.

6.5.3 Consultation questions

Q15 Do you agree with our preferred option of no longer publishing charges on behalf of companies?

7. Splitting charges

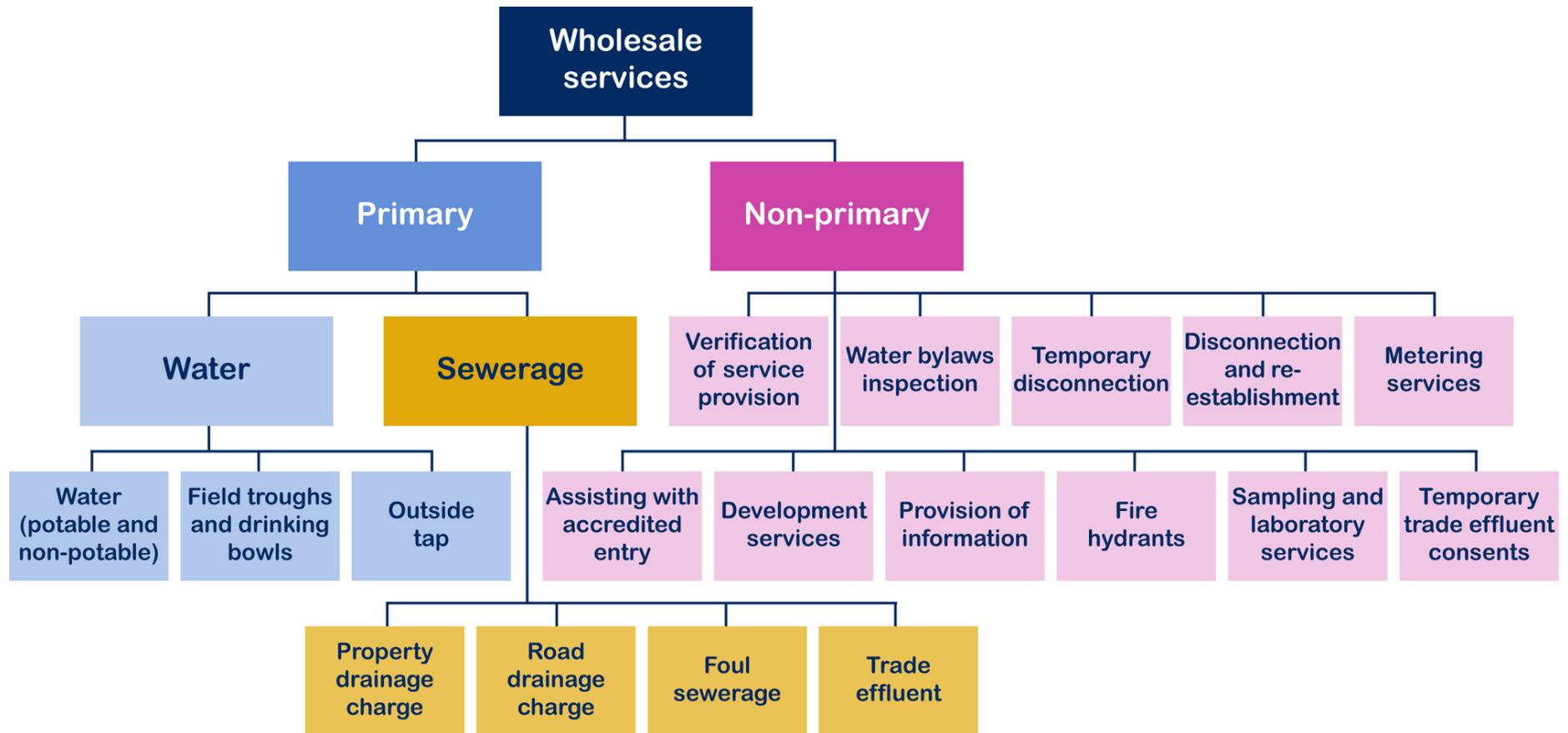
This will be the first time that companies will be required to split their wholesale and retail charges.

We currently consider that there are three broad approaches to splitting wholesale and retail charges.

- **Top-down.** Starting from their existing charges, companies work backwards to deduct a retail component to leave the underlying wholesale charge. This approach should limit incidence effects, but may result in poor cost reflectivity of wholesale charges.
- **Bottom-up.** Companies develop wholesale and retail charges independently and sum the two. This approach could enable improved cost reflectivity of wholesale tariffs, but may result in more incidence effects than the top-down approach.
- **Combination.** Such an approach could start from the basis of the top-down approach, but tailor charges to a degree using some bottom-up models.

The suitability of each approach may depend heavily on the nature of the charging rules we set (see above). Given this key interdependence, we welcome views from respondents on how best to split charges, along with example of any models they may have developed for such purposes. In publishing the conclusions of this consultation, we may choose to summarise the various approaches, potentially providing our views on the benefits and pitfalls of any approaches provided.

Appendix 1: Scottish Water's charges





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