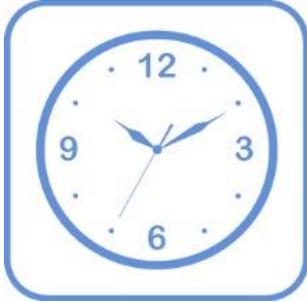




Charging working group

Meeting 3
17 April 2014

Agenda



Introduction (10 mins)

Objectives (20 mins)

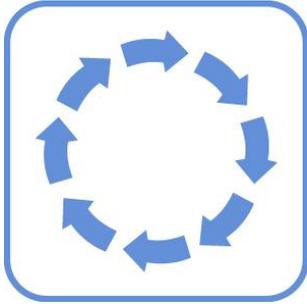
Bill stability (30 mins)

Cost reflectivity (30 mins)

Standardisation of wholesale charges (15 mins)

Other assumptions (30 mins)

Next steps (15 mins)

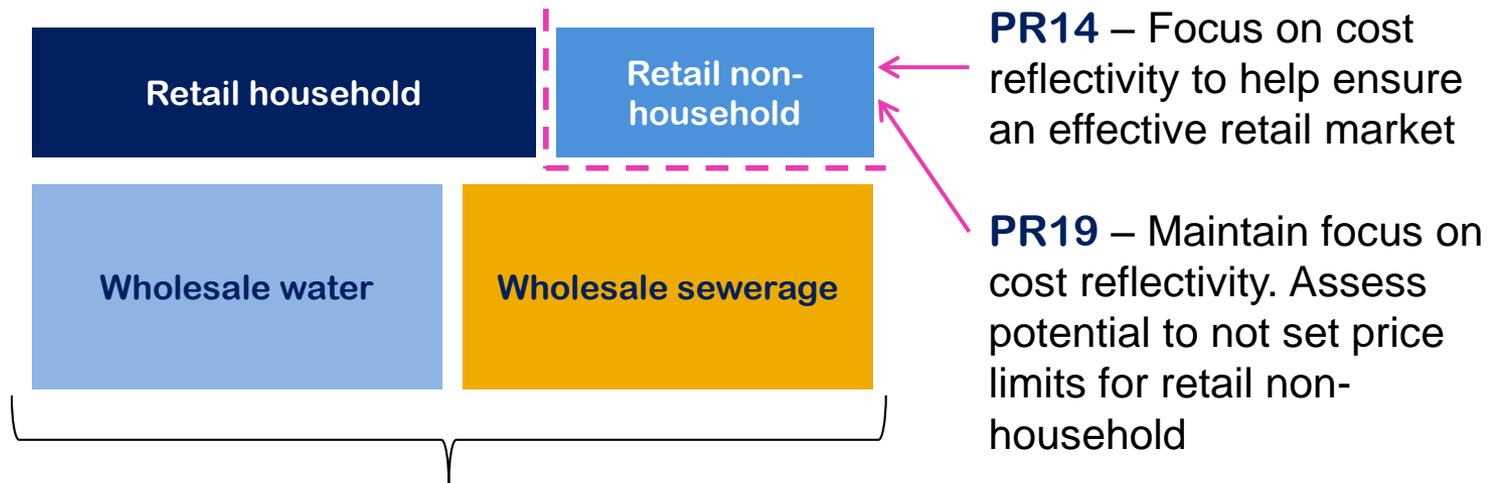


Following the wholesale and retail charging consultation and previous working group meetings, the following slides set out a series of 'minded to' positions for approaches to 2015-16 wholesale and retail charges.

Following this meeting and discussion with our Board next month, we will issue a consultation covering the issues discussed.

All contents of the subsequent slides are 'minded to' positions, and should not be considered as final Ofwat policy at this stage.

High level objectives (provisional)



PR14 – Focus on cost reflectivity to help ensure an effective retail market

PR19 – Maintain focus on cost reflectivity. Assess potential to not set price limits for retail non-household

PR14 - To allow some degree of flexibility to enable incidence effects to be managed during the transition to separate price controls.

PR19 - Throughout AMP6, further progress charging rules to explore options for improving cost reflectivity (e.g. area-based surface water drainage charges), and the revealing of further information through accounting separation, to provide the option at PR19 for separate network plus and resource price controls within the wholesale value chain. And to further assess the scope for the standardisation of wholesale charging structures.

What are the working group's views on the above objectives?



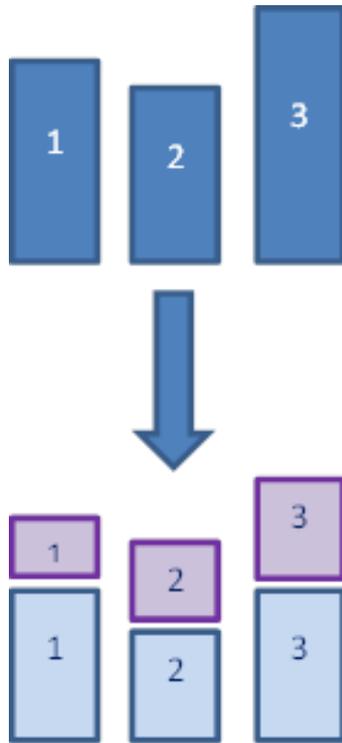
As 2015-16 will be the first year of separate wholesale and retail charges, we are minded to allow companies to manage incidence effects (to a degree) by adjusting their wholesale charges.

This would help manage overall bill stability while ensuring cost reflectivity of the retail component to prepare for market opening.

We could set a period for the initial rebalancing to take place over - for example, over three years, i.e. unwound by 2017-18.

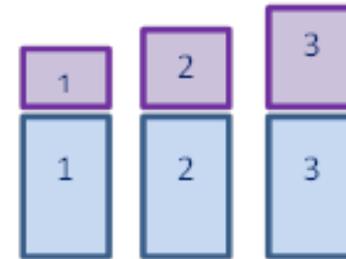
Bill stability (2 of 3)

Existing integrated bills for three different customers



Disaggregated bills, with wholesale charges adjusted to manage incidence effects

Disaggregated bills, with wholesale charges not adjusted to manage incidence effects



Note the bill increase for customer 2

By adjusting the wholesale charges, companies could manage incidence effects while ensuring that the retail component is cost reflective for different bands of customers

What are the working group's views on the above approach?



We are also considering whether to require that where bills are forecast to increase by more than a set figure (for a given type of customer) companies to undertake an impact assessment, and to demonstrate that they have considered using the range of tools available to them to manage any unacceptable effects.

We are minded to consider 5% to be an appropriate working assumption, and to request further views in the consultation.

What are the working group's views on the above approach?



As we are minded to allow an initial degree of flexibility in wholesale charges to manage incidence effects, this potentially results in less cost reflective wholesale charges for 2015-16 than otherwise could be the case.

This could be considered as a transitioning measure, with wholesale charges developing progressively over time to become more cost reflective.

We are minded to set some restrictions around how much wholesale charges are allowed to be 'flexed' to mitigate incidence effects arising from retail charge cost reflectivity.

For example, wholesale charges for core services should not be below avoidable costs, and revenue may not be moved between household and non-household without clear objective justification.

What are the working group's views on the above approach?



There are also some features of the existing framework we may wish to ensure are maintained, such as:

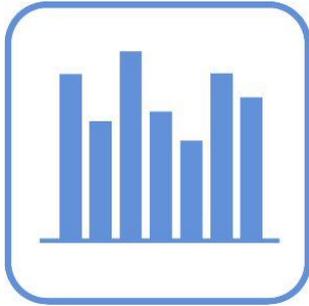
- the difference between metered and unmetered household customers to reflect any differences in costs of, and additional benefits to, one supply relative to the other;
- consistent principles and approaches to be applied across different classes of customers;
- large/intermediate tariff differentials to be based on cost differences associated with differential use of network assets, differential peaking characteristics, different service levels and different service measurement accuracy;
- in determining the balance between sewerage charges, companies should take into account the different pollutant loads associated with household foul sewage, non-household foul sewage, trade effluent and surface water/highway drainage waters;



...continued:

- companies to link their assessed charges as closely as practicable to the volume of water those customers would be likely to use if they had a meter;
- charging structures to reflect long-run costs (e.g. volumetric charges to form a larger component of the bill than implied by short-run costs);
- where companies have adopted differential peaking characteristics as a cost basis to support a non-household tariff, they should structure the resulting tariff on an appropriate peak demand basis; and
- trade effluent charges to be based on the Mogden formula (or variant of), or on a demonstrably more cost reflective basis.

What are the working group's views on the above approach?



We are minded to not set any structural standardisation requirements for wholesale charges for 2015-16.

However, we are minded to get companies to populate a standard schedule (similar to the one Anglian Water produced) so that they are all presented in the same way.

Having a standard method for presentation may help facilitate the debate as to the appropriate level of structural standardisation in the future, as well as providing some initial transparency to retailers.

What are the working group's views on the above approach?



As 2015-16 will be the first year of separate wholesale and retail charges, we are minded to require companies to provide some information for 2015-16 in advance of the start of the new controls and charges, similar to the existing principal statements.

We are minded to require companies for 2015-16 to publish their wholesale and end-user retail charges by 2 February 2015.

In future years we are minded to require wholesale charges to be published earlier to enable new entrants to develop their own retail charging proposals ahead of the new charging year. However, given the timing of the price review and the need to have regard to government's expected consultation on guidance, it may not be feasible to set an earlier deadline for wholesale charges, and end-user charges cannot be delayed as some companies start to issue bills around the beginning of February.



Companies have sought confirmation from Ofwat as to whether they will need to show separate wholesale and retail charges on the bills they send to customers.

As there are arguments both ways for this, we are minded to request further views from stakeholders through the consultation, and that for 2015-16 we expect companies to engage with their customers on what/how information should be presented.

We also expect companies to engage with CCWater in making significant changes to their charging schemes.

What are the working group's views on the above approach?

Other assumptions (1 of 2)



The Government's principle that household customers 'will not subsidise the development of competitive markets for business customers' may mean that wholesale costs relating to market readiness and the Open Water programme should not be recovered evenly across wholesale charges, as - even if we expect household customers to benefit through 'spillover' efficiencies - household customers would be contributing towards these costs.

If the costs were allocated to the non-household retail control this could risk distorting the market as incumbent retailers would bear higher costs than entrants.

We are minded to require that these costs should be recovered through a ring-fenced element of wholesale charges made to non-household customers only, proportioned in line with the size of the expected bill for each class of customer.

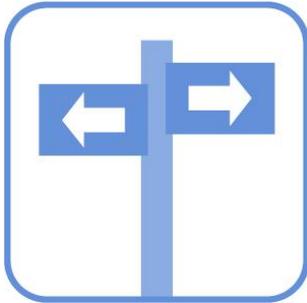
What are the working group's views on the above approach? 14



As per our information notice '[IN 13/19 Allocation of social tariff and surface water drainage concessions cross-subsidies](#)' we are minded to restate that social tariffs should be administered through the household retail controls (i.e. not reflected in wholesale prices), and surface water drainage concessions should be administered at a wholesale sewerage level (i.e. reflected in wholesale charges).

What are the working group's views on the above approach?

Next steps



Wholesale and retail charging reforms could be considered in two phases: preparation for 2015-16, and then progressive development beyond.

Are there any other key activities that need to take place ahead of 2015-16?

Does the working group have any views on what should be the priorities for the development of charges beyond 2015-16?

Thank you for your time