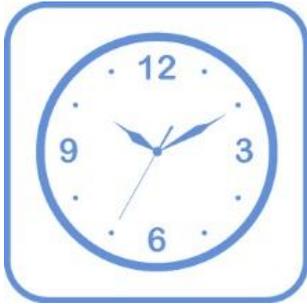




Charging working group

Meeting 1  
31 January 2014

# Agenda



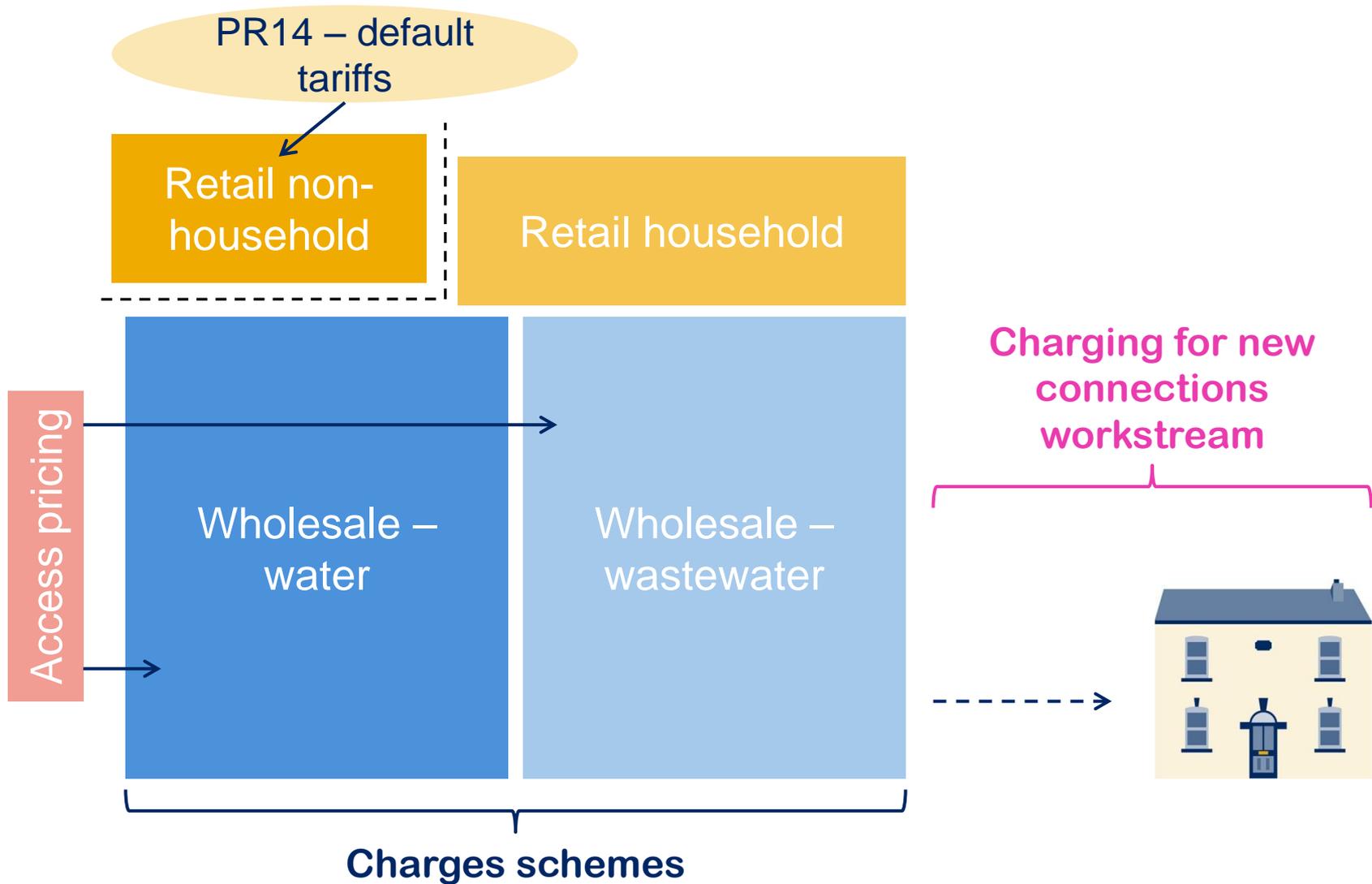
Introduction (15 min)

Objectives of charges schemes (70 min)

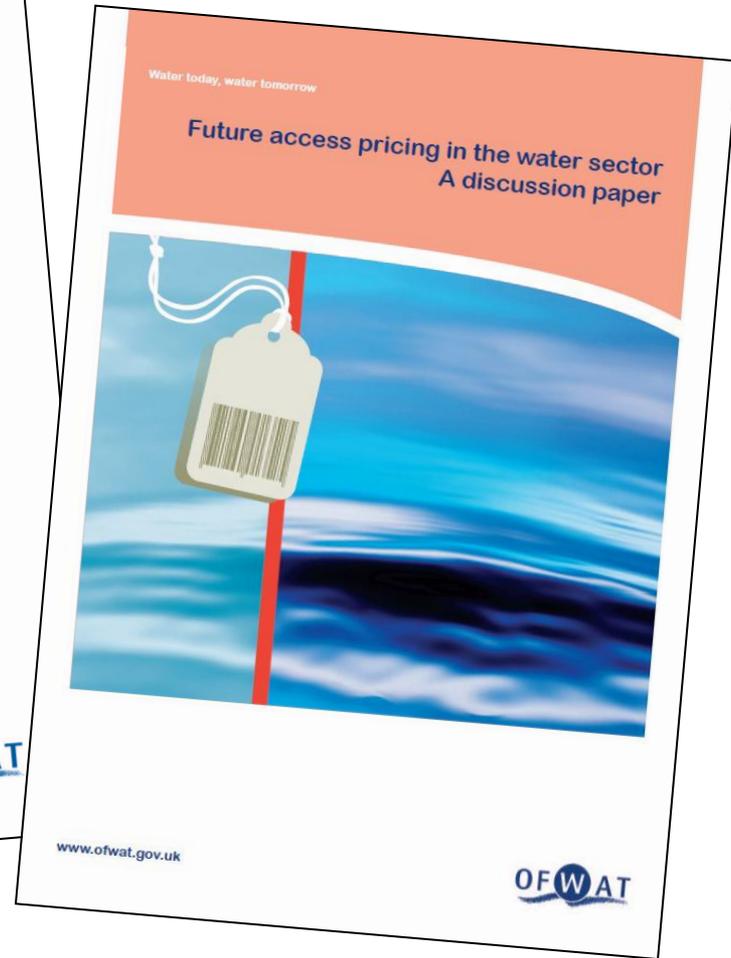
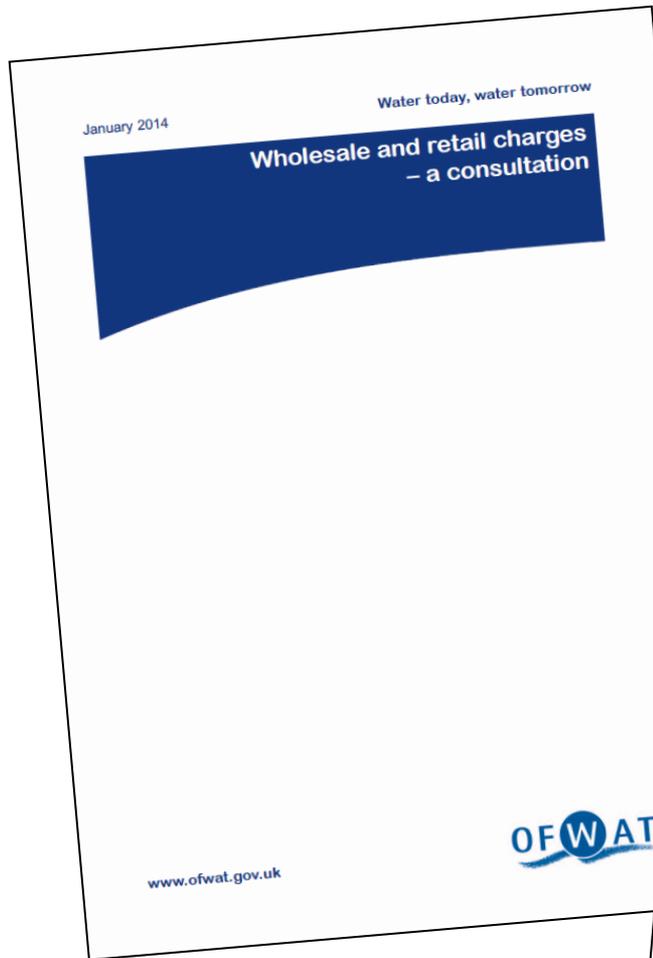
Access pricing (20 min)

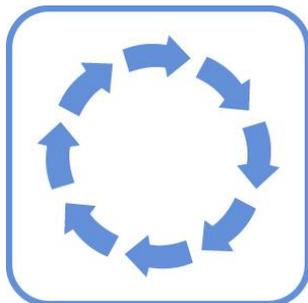
Agree actions (15 min)

# Introduction



# Charges schemes and access pricing





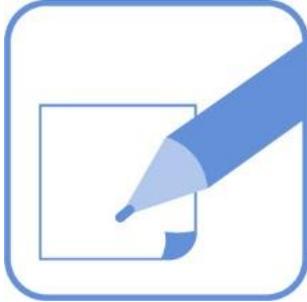
Under the current framework, companies submit their charges schemes to Ofwat which then approves the schemes before they come into effect

New legislation set out in the Water Bill will allow Ofwat to produce charging rules, which companies' charges schemes must comply with, and removes the requirement for charges schemes to be approved by Ofwat

In setting these rules, we will have regard to any guidance issued by the Secretary of State for Environment, Food and Rural Affairs, and Welsh Ministers

This will also be the first time that companies will have to split their charges between wholesale and retail

# What are rules?

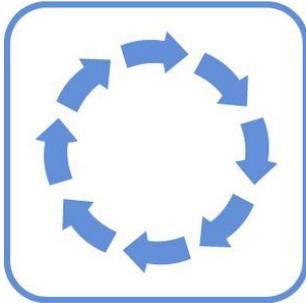


Rules may in particular –

1. Make provision about the types of charges that may be imposed
2. Make provision about the amount or maximum amount, or the methods for determining the amount or maximum amount, of any type of charge
3. Make provision about the principles for determining what types of charges may or may not be imposed
4. Make provision about principles for determining the amount of any charge that may be imposed
5. Require particular schemes of charges to be available in specified cases
6. Make provision about the timing of payment of charges
7. Require charges schemes to be published
8. Make provision about how charges schemes are to be published

# Timetable – charges schemes





Access to a monopoly company's water supply and sewerage infrastructure may include access to:

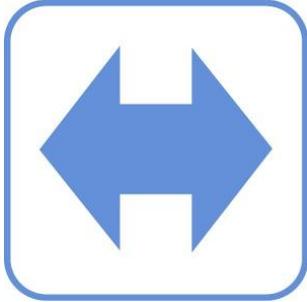
- Networks
- Storage facilities
- Treatment works

For example, a new entrant could apply for a 'wholesale authorisation', which would enable it to introduce water into the supply system of an existing monopoly company in connection with an intended supply under a retail authorisation, although not necessarily its own. So, the monopoly company will charge a price for moving the new entrant's water through its pipe network

A new entrant may also wish to purchase a range of other services from the monopoly company

Upstream reforms will be implemented after 2019

# Terms of reference



Does the group have any proposed changes to the draft terms of reference?



# 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

Our existing charging principles require companies to develop strategies to handle any incidence effects of changing tariffs

Changing the design of tariffs could lead to step changes in customers' bills. Rules could be set for companies to use glide paths in the event of significant changes in charging methodologies

There could also be other approaches we could explore in encouraging smooth bills



**More than eight in ten (81%) customers stated<sup>1</sup> that they would prefer to see “bills change steadily every year throughout the period, so that customers do not see big changes from year to year”**

<sup>1</sup> MVA Consulting report for Ofwat, Defra, Welsh Assembly Government, CCWater, Environment Agency, DWI, Natural England and Water UK (2009) – Understanding customers' views

# Bill stability – potential options

1. Carry out a proportionate impact assessment and develop a strategy for handling any incidence effects of significant changes to charges
2. Follow the above rule, but also complying with specific requirements that Ofwat sets for such strategies (such as the level of engagement with customers, and considering a range of mitigation techniques)
3. Use glide-paths to transition to new arrangements for wholesale and household retail charges
4. Follow the above rule, but also comply with specific requirements that Ofwat sets for how such glide-paths should be applied (such as 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)

**Any high-level views on these options?**

**Are there any other viable options?**

# Cost reflectivity

Cost reflectivity promotes efficiency when parties pay for the costs they create and greater efficiency means lower bills to customers overall

While total de-averaging of prices is not technically feasible, politically acceptable, nor even economically preferable, there may be some options to improve the effectiveness of cost signals sent



**The Water White Paper describes a vision in which water is valued as the precious resource it is**



It has been our policy since 2003 that charges should more closely reflect how much surface water drains off a property. Currently only four companies base their charges for SWD on the area of the site

There may be some scope to increasingly reflect the spatial variations in the costs of water resources in charges. Companies already assess the LRIC of developing water resources at a WRZ level. However, it should be noted that water resources comprise a relatively small part of the overall bill

**Any high level views on these options?**

**Are there any other areas where improved cost signals could improve outcomes?**

# Standardisation

We may wish to specify a degree of industry-wide standardisation in wholesale tariff structures. Standardised wholesale tariffs could help facilitate an effective retail market. However, requiring standardised tariffs would reduce the scope for companies to develop innovative and beneficial tariffs

There are a number of options for standardisation, each will have different impacts in terms of company accountability, flexibility, innovation, transparency, and overall complexity. There could also be incidence effects to end-user bills of standardising tariffs

No standardisation

Full standardisation

Some standardisation  
driven through high-  
level rules

Prescribed standardisation  
of core charges, allow  
companies to develop  
tariffs for other services

Ofwat sets tariff  
structures

# Types of standardisation



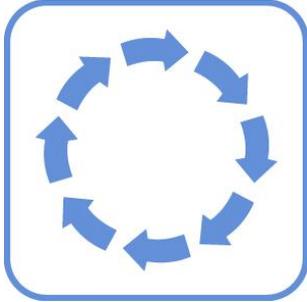
Standard use of terms and language used in charges schemes

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

**What (if any) types of standardisation should we be pursuing?**



What issues does the group envisage in companies splitting wholesale and retail charges?

How easy would it be to implement some of the options we have discussed today?

Are there any areas we should be prioritising?

What might the incidence effects be from some of the options we have discussed?



# Main issues

## Preventing monopoly abuse

Incumbent companies will remain vertically integrated. Therefore charges will need to be set on a non discriminatory basis for third parties

## Selecting the right level of cost information

The more detailed the cost information used, the more the effective the price signals that access pricing could send. But asking companies to collect more data bears a cost

## De-averaging

Effective price signals for access will require some consideration of local costs. There are a number of approaches that could be used to limit the effect on end customers' bills

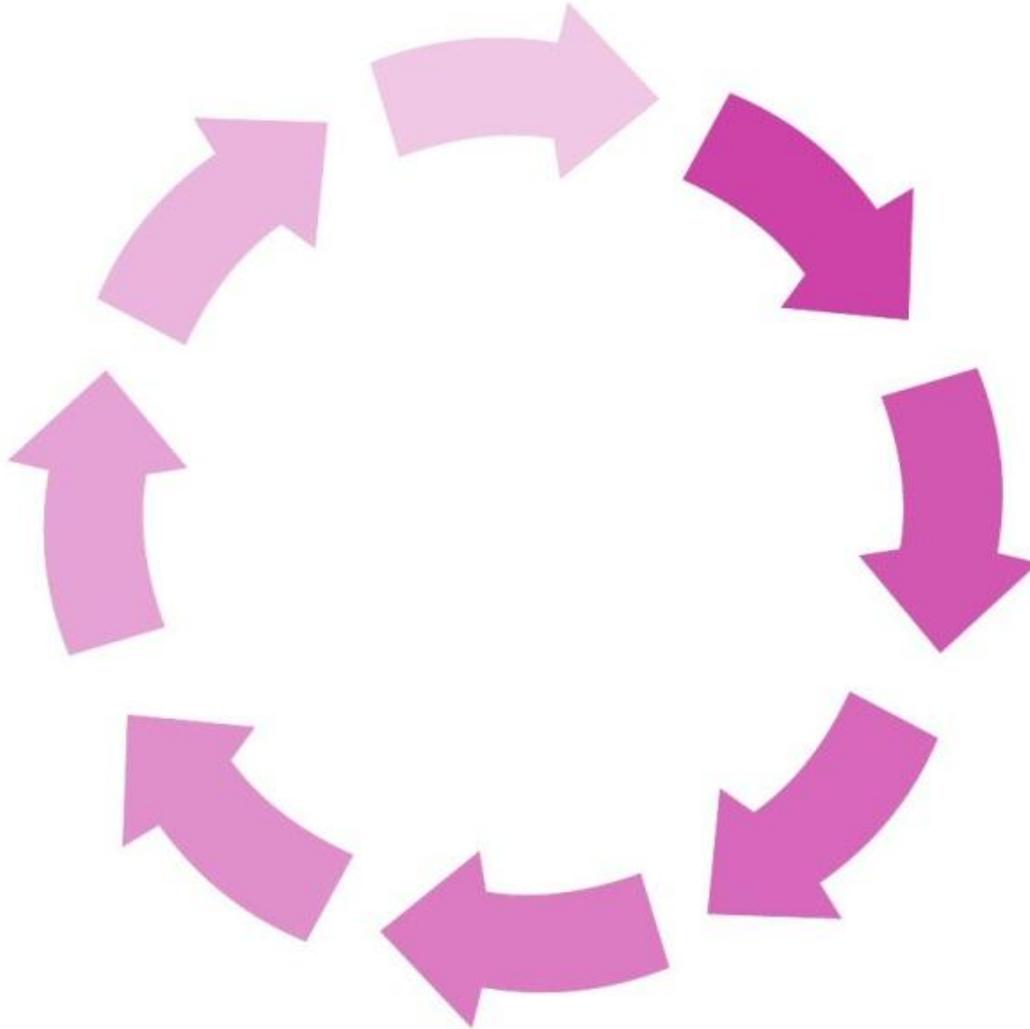
## RCV discount

The industry's RCV is about 12% of net MEAV. This creates challenges in setting cost reflective access prices that enable competition on a level playing field

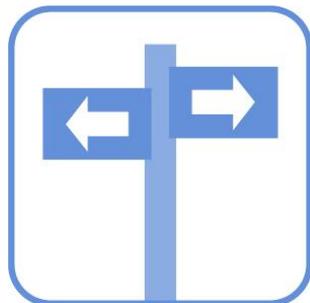
# Main issues

<p><b>Helping the environment</b></p> <p>Access pricing will need to stay flexible to future abstraction reform</p>	<p><b>Interactions with the 2014 price review</b></p> <p>Access pricing will need to suitably align to our price control incentives, so that there are no unintended distortions in the incentives that companies face</p>
<p><b>Interactions with the Open Water programme</b></p> <p>The Open Water programme will facilitate the implementation of market reform. Any processes or systems it develops will need to enable the new access pricing framework</p>	<p><b>Are there any other key issues?</b></p>

## Next steps and actions



# Future discussion areas



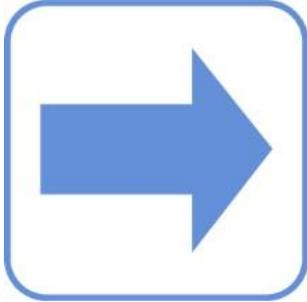
Developing today's discussions

Mandatory allocations

Governance and process

Guidance to ensure charges are split in a way that does not have any unintended effects

**Are we missing anything?**



**Could working group members provide for the next meeting:**

1. Proposed approaches to split wholesale/retail charges that could be flexible to the options we discussed today
2. An incidence effects analysis of the options we discussed today

Is there anything about this meeting that members would like run differently for next time?

Proposed times for next meeting

**Thanks for your time**