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Trust in water

# Consultation on wholesale charging rules

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## About this document

From 1 September 2016 (following amendments to the Water Industry Act 1991) we will have a duty to set the rules that wholesalers must use when setting their charges for wholesale services.

Our proposed rules will apply to wholesalers whose area is wholly or mainly in England and for those wholesalers whose area is wholly or mainly in Wales.

This document is the **statutory consultation on our draft wholesale charging rules**.

Responses to this consultation are due by **9 September 2016**.

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## Summary

From April 2017, 1.2 million businesses, charities and public sector organisations (businesses) that are customers of providers wholly or mainly in England will be able to choose their supplier of water and wastewater retail services.<sup>1</sup> The Welsh Government has decided that the scope for retail competition in Wales will remain at current levels, so businesses, charities and public sector in Wales will be able to choose their supplier of water (but not wastewater services) if their premises are supplied with at least 50 mega litres of water a year.

Ahead of the opening of the English retail business market we are consulting on the wholesale charging rules that will apply in both England and Wales.<sup>2</sup> As wholesale charges typically represent around 90% of the costs ultimately faced by a business customer, having clear and transparent wholesale charges will be key to ensuring the development of an effective English retail business market and for the part of the Welsh retail business market that is contestable. But beyond the competitive retail market, our new wholesale charges rules will bring benefits in terms of greater transparency of charges and improve the accountability of wholesalers for their charges and the impact they have on retailers and on end customers.

Our draft wholesale charging rules aim to ensure that wholesalers<sup>3</sup> wholly or mainly in England and wholesalers wholly or mainly in Wales better understand their costs and cost drivers, and that new retailers<sup>4</sup> and associated retail companies of existing water companies are clear what they are paying for. They also look to ensure that the benefits associated with the effective use of markets can be realised by new retailers and associated retail companies of existing water companies, and all

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<sup>1</sup> In this document we also use the terms ‘businesses, charities and public sector organisations’ and ‘businesses’ to refer to persons occupying non-household premises.

<sup>2</sup> This document is the statutory consultation required by sections 66EB and 117K of the Water Industry Act 1991.

<sup>3</sup> In this document we use the terms ‘wholesaler’ and ‘wholesalers’ to refer to companies holding appointments as water undertakers and/or sewerage undertakers insofar as those companies are carrying out wholesale activities.

<sup>4</sup> In this document we use the terms ‘retailer’ and ‘retailers’ to refer to persons holding water supply and sewerage licences with retail and/or restricted retail authorisations.

eligible business customers – businesses, public sector bodies and charities in England and business customers using more than 50MI of water a year in Wales.<sup>5</sup>

In developing our draft wholesale charging rules we have had regard to the [Charging guidance to Ofwat](#) issued by the UK Government and the [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) issued by the Welsh Government. We have also looked to encourage the development of markets in England and in the part of the market that is contestable in Wales by ensuring fairness and affordability, environmental protection, stability and predictability, and transparency and customer-focused service. Our approach will also help retailers to drive efficiency in the wholesale market as they compare (and question) the wholesale charges that have been proposed by wholesalers.

Recognising that there are considerable differences in the structure of charges between wholesalers and that increased standardisation of charging structures could reduce complexity, we are proposing a rule that will require wholesalers wholly or mainly in England and wholesalers wholly or mainly in Wales to consider ‘general charging principles’ when setting their wholesale charges, which we expect will promote some consistency across wholesalers. But, we are not proposing to design and specify wholesalers’ tariffs. Consistent with our strategy – being clear on the expectations companies face, and enabling and incentivising them to deliver against those in efficient and innovative ways – we will leave it to wholesalers wholly or mainly in England and wholly or mainly in Wales to innovate and, design and specify their own wholesale tariffs.

As we want to ensure a level playing field across England and in the contestable business retail market in Wales we are proposing that wholesalers wholly or mainly in England and wholesaler wholly or mainly in Wales outline what they expect their primary wholesale charges<sup>6</sup> to be – for all retailers – three months in advance of issuing their final wholesale charges.<sup>7</sup> We refer to these charges as indicative wholesale charges. Publication of indicative wholesale charges will ensure that all retailers in England and Wales are clear what they are paying for and can respond

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<sup>5</sup> Information on eligibility is available through our [Eligibility guidance on whether non-household customers in England and Wales are eligible to switch their retailer](#) and [Supplementary guidance on whether non-household customers in England and Wales are eligible to switch their retailer](#).

<sup>6</sup> Primary wholesale charges are the charges that typically involve meter based annual charges and/or volumetric charges.

<sup>7</sup> We are also proposing that wholesalers issue their final wholesale charges at least 11 weeks before the start of the period in relation to which they apply. We assume that a charging year will remain as a year commencing from 1 April, not least as the processes that have been designed by MOSL (for retail market opening in England) have been aligned to the April – March timeframe.

appropriately. We are also proposing that if a wholesaler is considering significantly altering its wholesale charges that retailers are notified of this at least six months prior to the publication of their final wholesale charges.<sup>8</sup> This approach should provide retailers sufficient time to consider their response to any proposed changes to wholesale charges, develop their (retail) pricing strategies and engage with their customers. This approach should also increase the pressure on wholesalers to better understand their own costs and cost drivers.

Companies' Boards will also be asked to provide us assurance that their indicative wholesale charges are accurate and have been appropriately considered. A similar level of Board assurance will also be required for their final wholesale charges. Requiring Board assurance will help ensure that Boards are engaged with their wholesale charges and take ownership of their charges being fair and reasonable (and are accurate both in terms of ensuring their continued compliance with their licence obligations and their obligations under competition law).

As part of these Board assurances that are prepared by companies' boards for us we are also proposing that a proportionate impact assessment is produced where the wholesale charges faced by retailers (as a whole or in groups) are expected to increase by more than 5% from the previous year. And, as wholesale charges typically represent around 90% of the costs ultimately faced by a business, we will require wholesalers to engage directly with business customers (as a whole or in groups) and consider the impact that their proposals will have on their bills. These requirements will ensure that wholesalers wholly or mainly in England and wholesalers wholly or mainly in Wales have appropriately engaged stakeholders in developing their wholesale charges, and have revised their charges as appropriate, and have included any appropriate transition arrangements.

We are also proposing a rule that will require wholesalers wholly and mainly in England and wholly and mainly in Wales to clearly identify the different wastewater services charges that they offer to retailers. Wholesalers wholly or mainly in England will also be required to separate out the different wastewater services charges that they offer to all retailers in England by April 2020.<sup>9</sup> Wholesalers wholly or mainly in England are therefore encouraged to start considering how they will separate out

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<sup>8</sup> The information provided as part of this notification need not be as comprehensive as the information contained in their indicative charges and/or any statement of significant changes (see chapters 3 and 4).

<sup>9</sup> We do not currently consider that this requirement is appropriate for wholesalers wholly or mainly in Wales due to the levels of competition in Wales remaining at current levels and given the key themes outlined in the Water Strategy for Wales (see chapter 2).

their charges for the treatment of trade effluent, foul water, highway drainage and surface water drainage. And, while separating out of the different wastewater services charges may not occur immediately in England, we will be requiring wholesalers operating wholly or mainly in England and wholesalers wholly or mainly in Wales to ensure there is transparency about the different services included within their wastewater charges. This level of transparency will ensure that retailers in both England and Wales are clear what they are paying for and can respond appropriately, including by putting more pressure on wholesalers to better understand their own costs and cost drivers.

Wholesalers will also be required to clearly state what concessionary surface water drainage discounts may be available in England and Wales and how these discounts may be accessed. Requiring wholesalers to provide this information to retailers should allow retailers to make timely decisions about discounts for their customers.

To facilitate transparency and the completeness of wholesale charges we are also proposing that wholesalers wholly or mainly in England (which includes small new entrants (often referred to as “NAVs”) and Cholderton and District Water Company Limited) include the following information when they publish their wholesale charges:

- information on their primary charges – these are the charges that typically involve meter based annual charges and/or volumetric charges for the provision of a supply of water, or sewerage services, to premises; and
- information on a minimum list (as set by us) of the charges for non-primary services provided by wholesalers directly to customers. Examples of non-primary charges include charges for disconnection, meter testing, provision of fire hydrants and pressure tests. And, where it is not possible for these non-primary charges to be determined in advance, wholesalers will be required to outline the methodology that they will use to calculate those charges.

Wholesalers wholly or mainly in England and wholesalers wholly or mainly in Wales that provide retail services direct to business customers are allowed to set their charges in accordance with a statutory charges scheme or on the basis of an agreement with a business. Where agreements are used we refer to these as special agreements. As we want new retailers to compete for eligible business customers that are on special agreements in England and Wales, we expect wholesalers to publish the wholesale charges for eligible business customers who are currently on special agreements with their wholesale charges. This requirement will be in addition to the current requirement that they notify us of the provisions of special agreements and provide us details on an annual basis. Taken together, these proposals will increase transparency and ensure retailers are aware of the margins that are potentially available.

## Consultation questions

Q1 Do you have any specific views on the draft wholesale charging rules included in appendix 1? Are there additional rules that we should include in the future?

Q2 Do you agree with our proposed threshold (5%) for significant bill increases, above which wholesalers will be required to undertake an impact assessment for changes to charges?

Q3 Do you agree with our proposal not to set rules requiring standardisation of wholesale charges at this point, but to consider this issue further, following market opening, taking account of any progress by industry to develop standardised charging structures and the benefits from that standardisation?

Q4 Do you consider that requiring wholesalers to provide an update on potentially significant changes to their wholesale charges six months before their final charges are published is appropriate? And, do you consider that requiring information on their primary indicative wholesale charges three months before any new charges are published is reasonable?

Q5 Do you agree that requiring company Board assurance for indicative primary wholesale charges is reasonable? And, where there are significant changes in the level of charges in the three months between indicative and final charges, is it reasonable to require a Board to issue, as part of their board assurance, a statement explaining why this has occurred and why this was not anticipated?

Q6 Do you agree with wholesalers being required to inform retailers of the separate prices for the different wholesale wastewater services they are being provided with? And, do you agree that it is appropriate that wholesalers should be required to consider how they will separate out – having considered the costs of these services and having appropriately engaged with their stakeholders – the different wastewater services they provide to their customers in England and Wales by April 2020?

Q7 Do you agree that a minimum list of non-primary charges should form part of all wholesale charge schemes? Do you agree that wholesalers, and not Ofwat, should look to ensure greater consistency in the terminology used to describe non-primary charges?

Q8 Do you agree with our proposals that wholesalers will be required to publish the methodology underpinning non-primary charges for a limited set of charges where

these charges cannot be set in advance? Is this approach proportionate and will it be effective?

Q9 Do you agree that our approach to concessionary drainage charges will ensure appropriate transparency in these charges?

Q10 Do you agree that our proposal requiring wholesalers to publish the wholesale charge for any customer on a special agreement are proportionate and will be effective?

Q11 Do you have a view on the most appropriate approach to dealing with back billing – for example, would a general obligation in either the licence or the Wholesale-Retail Code, or a rule in the wholesale charging rules be more appropriate?

Q12 Do you agree that our proposed rule requiring NAVs in England and Cholderton and District Water Company Limited to publish wholesale charges will achieve our aims in a proportionate way?

Q13 Do you agree with our approach to Board assurance? And, do you agree with our preference for wholesalers to submit (where appropriate) a statement of significant change for primary wholesale charge at least three months before final wholesale charges are published?

## Responding to this consultation

We invite responses to this consultation by **9 September 2016**.

You can email your responses to [Charging@ofwat.gsi.gov.uk](mailto:Charging@ofwat.gsi.gov.uk) or post them to:

Charging  
Ofwat  
21 Bloomsbury Street  
London  
WC1B 3HF

We will publish responses to this consultation on our website at [www.ofwat.gov.uk](http://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. Background and context

Amendments made by the Water Act 2014 to the Water Industry Act 1991 mean that we are required to set wholesale charging rules.<sup>10</sup> In setting these rules we must have regard to guidance issued by the UK Government and the Welsh Government, and consult the relevant persons about our draft rules.

Setting clear wholesale charging rules that wholesalers wholly or mainly in England and wholly or mainly in Wales need to comply with contributes to the delivery of our strategy – being clear on the expectations companies face, and enabling and incentivising them to deliver against those in efficient and innovative ways. For example, our rules outline the principles that a wholesaler should consider when developing its charges but do not dictate what services should be provided or what the charges for those services should be. Similarly, while our rules require consistency in the principles and methodology applied to calculate charges for different classes of customers, they do not specify what specific calculations should be used.

Our main tools to limit charges, including wholesale charges, are the price controls that we set. At PR14 we set either average or total revenue price controls for wholesale water, wholesale wastewater residential retail and business retail. So, for example, for large wholesalers we set total revenue controls that covered all revenues from wholesale activities, including cash and revenue receipts from connection charges, with a duration of five years. They are then free to set their charges within the constraint of legislation to recover their allowed revenues. In other words, our approach did not look to limit the individual prices that a wholesaler may set for the services that they provide. Small wholesalers – NAVs and Cholderton and District Water Company Limited – have either simplified or relative price controls.

We require<sup>11</sup> large wholesalers wholly or mainly in England and wholly or mainly in Wales to publish their charges to demonstrate compliance with our wholesale price controls. Wholesalers publish these charges in documents called “wholesale charges publications” or “wholesale charges schemes”<sup>12</sup>. These wholesale charges schemes

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<sup>10</sup> A charges scheme is the legal statement of a company’s charges and associated terms which applies to the vast majority of its customers.

<sup>11</sup> In accordance with Condition B (Charges) of their appointments (‘licences’).

<sup>12</sup> These documents are not covered by our charges scheme rules, because our charges scheme rules only apply to statutory charges schemes setting out end-user charges that are issued under section 143 of the Water Industry Act 1991.

set out both the charges for retailers and those that apply internally where they are providing retail services direct to business and residential customers.

Within the constraints of our price controls, wholesale charging rules play an important role in driving efficiency and increasing transparency, and enabling appropriate and effective use of markets. Specifically, wholesale charges that reflect the costs of providing wholesale services send signals that enable and incentivise the creation of value through the re-consideration of those costs and the search for efficiency. It also provides information to market participants on whether to supply or not, or whether to make or buy. These are particularly important issues if we want to see effective decision making by wholesalers wholly or mainly in England and wholly or mainly in Wales, and if we want to see markets develop – be it the English business retail market, the contestable business retail market in Wales, the water resources market or the bio-resources market.<sup>13</sup>

The predictability and stability of wholesale charges is important if we want to ensure an effective English retail business market and in the part of the Welsh business retail market that is contestable. And, in developing our wholesale charging rules we have carefully balanced the objectives of predictability and stability against other objectives, including ensuring cost reflectivity.

Our wholesale charging rules for England and Wales will also need to evolve over time, not least as markets develop and new information becomes available to us and to market participants. The draft wholesale charging rules that we have proposed therefore represent the first step in this journey.

The UK Government and the Welsh Government have power to issue charging guidance to Ofwat and we must have regard to any relevant charging guidance when setting our rules. On 29 January 2016, the UK Government published its [Charging guidance to Ofwat](#) (for wholesalers whose areas are wholly or mainly in England) and this consultation demonstrates how we have had regard to this guidance in developing our draft wholesale charging rules. The Welsh Government has also consulted on its draft guidance in [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#), for wholesalers whose areas are wholly or

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<sup>13</sup> For more information on promoting effective markets see: [Towards Water 2020 – policy issues: promoting markets](#).

mainly in Wales.<sup>14</sup> We have had regard to both these documents in developing our draft wholesale charging rules.

Our wholesale charging rules will be issued under:

- section 66E of the Water Industry Act 1991 (as substituted by paragraph 5 of Schedule 2 to the Water Act 2014) in relation to the charges made by a water undertaker to a water supply licensee; and
- section 117I of Water Industry Act 1991 (as inserted by Schedule 4 to the Water Act 2014) in relation to the charges made by a sewerage undertaker to a sewerage licensee.

We are required to carry out a formal statutory consultation on our draft wholesale charging rules before we can issue them. The rules will apply to all wholesalers (including NAVs and Cholderton and District Water Company Limited) wholly or mainly in England and wholly or mainly in Wales.

Following consultation on our draft wholesale charging rules we shall set our final wholesale charging rules for England and Wales in time for April 2017.<sup>15</sup>

In chapter 2 we discuss the issues raised in the UK Government's [Charging guidance to Ofwat](#) and the Welsh Government's [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) and how we have looked to meet the objectives raised in those documents.

In chapter 3 we discuss our proposed approach to standardisation of wholesale charging structures, timing, transparency of wastewater charges, completeness of wholesale charges, concessionary drainage charges, special agreements, back billing and small companies.

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<sup>14</sup> The Welsh Government has yet to issue its final charging guidance to us. Once it has issued this guidance to us we will consider whether, having regard to that guidance, it is appropriate to amend our rules.

<sup>15</sup> In developing our proposals it is worth noting that retail market opening will predicate a number of changes and one of those will be with respect to the wholesale retail code. As this code will be subject open governance, parties will be able to identify and put forward changes to it over time.

In chapter 4 we discuss the information that companies will need to submit in advance or alongside their wholesale charges to provide assurance under the new regime.

In chapter 5 we discuss our next steps.

Appendix 1 sets out our draft wholesale charging rules for England and Wales.

Appendix 2 provides information on how our proposed wholesale charging rules interact with other elements of the regulatory framework.

## 1.1 Existing duties and obligations

In setting wholesale charges, wholesalers wholly or mainly in England and wholly or mainly in Wales have a series of duties and obligations with which they must comply. These include (but are not limited to) the following.

- **Price controls.** A wholesaler will have obligations to comply with their price controls (licence condition B).
- **Licence conditions.** A wholesaler will have licence conditions that require them not to show undue preference or undue discrimination:
  - in setting charges for classes of end-user customers (licence condition E); or
  - in relation to a retailer, as compared with any other retailer or the wholesaler itself (licence condition R).
- **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 position. Where anti-competitive agreements or conduct are reasonably suspected, we have concurrent powers with the Competition and Markets Authority to investigate and take appropriate enforcement action.
- **Social tariffs and surface water drainage concessions.** As provided for by the Flood and Water Management Act 2010, a wholesaler may, where they provide retail services to end-users, provide in their statutory charges schemes for reduced charges to community groups in respect of surface water drainage from their property, where the charge is based on the surface area drained. If they include any such provision, they must have regard to the relevant guidance issued by the UK Government (in the case of wholesalers wholly or mainly in England) and the Welsh Government (in the case of wholesalers operating wholly or mainly in Wales).

It will be wholesalers' responsibility to ensure that they comply with these obligations as non-compliance can involve penalties (as well as reputational damage).<sup>16</sup>

## 1.2 Other relevant publications

In May 2013, the UK Government published its [Strategic policy statement to Ofwat](#) (incorporating its social and environmental guidance). This statement identified priorities which the Government expects us to reflect in our decision making. On 30 October 2013, the UK Government published a set of [Principles governing future water charges](#). These principles have underpinned the development of the charging guidance that the UK Government has since issued.

In December 2013, the Welsh Government published its [Social and Environmental Guidance to Ofwat](#). This guidance, along with the [Social Tariff guidance](#), is expected to underpin the final charging guidance that the Welsh Government will issue to us.

In January 2014, we published '[Wholesale and retail charges – a consultation](#)' that set out a series of key themes for consideration in setting future charging rules, as well as features of the overall charging framework.

In May 2014, we built on our January consultation with a [Consultation on wholesale and retail charges for 2015-16 and charges scheme rules](#). This set out our working expectations on how we envisaged companies to approach the development of their wholesale and retail charges for 2015-16. We published the responses to the May consultation in our [draft determinations \(technical appendix A8 – charging\)](#), and in November we set out our approach for the 2015-16 charging approval process in: [IN 14/17: Approval of charges 2015-16 – our approach, process and information requirements for large and small companies](#).

In August 2015, the Welsh Government issued its [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#). We have had regard to this document in developing our draft wholesale charging rules and will, if appropriate, look to amend our wholesale charging rules when the Welsh Government issues its final charging guidance to us.

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<sup>16</sup> For example, a wholesaler involved in anti-competitive behaviour could be directed to change its behaviour and risks being fined up to 10% of its turnover. It may also expose itself to possible damages actions. Furthermore, individuals could find themselves facing director disqualification orders or even criminal sanctions for serious breaches of competition law.

In September 2015, we published our [Consultation on charges scheme rules for 2016-17 and future developments](#), in which we set out our draft rules for retailers as well as some emerging thinking on wholesale charging rules and special agreements. And, in November 2015 we issued our charging rules for retail.

In January 2016, the UK Government published its [Charging guidance to Ofwat](#). This guidance has underpinned our approach to developing our wholesale charging rules (and is explored in more detail in chapter 2).

In March 2016, we published information notice [IN 16/02](#) that outlines our views on the timing of preliminary wholesale charges information for 2016-17 and special agreements.

In May 2016, we published [Customer protection final Code of Practice for non-household retailers](#) which has implications for how we have approached back billing for wholesalers.

## 2. Charging guidance

This chapter explores the issues raised in the UK Government's [Charging guidance to Ofwat](#) and the Welsh Government's [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) and how, in developing our wholesale charging rules, we have looked to meet the objectives raised in those documents.

This chapter is structured as follows:

- Section 2.1 outlines the UK Government's [Charging guidance to Ofwat](#) and how we have met the objectives outlined in that guidance. Specifically, we outline how our approach ensures fairness and affordability (section 2.1.1), environmental protection (section 2.1.2), stability and predictability (section 2.1.3) and transparency and customer-focused service (section 2.1.4); and
- Section 2.2 outlines the objectives raised in the Welsh Government's [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) and how our approach delivers excellent services to customers (section 2.2.1) and water for nature, people and business (section 2.2.3).

### 2.1 UK Government charging guidance

In January 2016, the UK Government issued its [Charging guidance to Ofwat](#). This guidance has four key objectives:

- fairness and affordability;
- environmental protection;
- stability and predictability; and
- transparency and customer-focused service.

The UK Government's guidance does not highlight which objective should take priority when we develop our wholesale charging rules. Rather it is left open to us to determine how we should best reflect those objectives in setting our wholesale charging rules. How we have met these objectives is outlined below.

#### 2.1.1 Fairness and affordability

The UK Government's [Charging guidance to Ofwat](#) outlines that ensuring current and future customers get a fair deal is key to charging. How we have looked to ensure this is achieved – by ensuring fairness and affordability – is outlined below.

## **Fairness**

As noted in chapter 1, charges rules sit within an overall framework of duties and obligations on companies, and this helps ensure fairness. For example, wholesalers must ensure that their wholesale charges comply with competition law.

A further way of ensuring that wholesale charges are fair is for charges to be recovered from different groups of customers and for any difference in the charges for those different groups to be based on clear and consistent factors, such as the cost differences associated with different use of assets and different service levels. We have therefore proposed a rule that will require this.

Fairness will also be ensured if wholesale charges suitably reflect the long-run costs associated with the wholesale service provided. As we expect wholesale charges to become more cost reflective over time, we have proposed that companies prepare, as part of their Board assurance process, a proportionate impact assessment if they expect the bills faced by retailers (as a whole or in groups) to increase by more than 5% from the previous year. And, given that wholesale charges typically represent around 90% of the costs ultimately faced by a business, we also expect wholesalers to consider the potential impact of changes to its charges on businesses. Where significant changes to wholesale charges are required, our rules will also require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans. Further information on how we are looking to ensure stable and predictable water bills is discussed in section 2.1.3.

Over the next few years we also intend to look further at wholesalers' costs, and we may therefore give further consideration to how wholesale charges are structured. We expect that new information will emerge, including as a result of pressure from retailers and from others looking to provide wholesale services. In addition, we expect that wholesalers will be continually looking to improve their understanding of their own costs and associated cost drivers.

We also see the charging rules framework as part of an evolutionary process whereby we progressively refine our wholesale charging rules to reflect lessons learned and information revealed through the way that we regulate, and the markets we monitor.

## **Affordability**

Our price controls, including those for wholesale activities, seek to protect customers (including certain groups of customers who are in need of protection) by, among

other things, setting revenue limits that reflect the efficient costs of delivering that performance. Licence condition B requires wholesalers to levy charges in a way best calculated to comply with our price controls. This provides an overall safeguard on charges set by them.

The legislative framework also makes allowances for vulnerable groups to receive special protections<sup>17</sup> in relation to charges made by both retailers and wholesalers. The Flood and Water Management Act (2010) allows<sup>18</sup> for concessionary surface water drainage charges to community groups. And, reflecting this, our wholesale charges rules require wholesalers to clearly set out the terms for these concessionary charges and to provide retailers with the same discounts that are offered to the wholesaler's own customers.

Affordability will also be ensured through companies preparing, as part of their Board assurance process, a proportionate impact assessment if the bills faced by retailers (as a whole or in groups) and businesses are expected to increase by more than 5% from the previous year – see earlier discussion. This is why where significant changes to wholesale charges are required, our rules require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans.

### **2.1.2 Environmental considerations**

The UK Government's [Charging guidance to Ofwat](#) sets out that securing the long-term resilience of supply systems and sewerage systems is important and that we must look to promote long-term thinking in the water industry and encourage the sustainable management and use of water resources.

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<sup>17</sup> Allowance for vulnerable groups include: (1) WaterSure – this is a scheme that caps the water bills of metered customers who are in receipt of certain benefits, if they have a large family, or if a member of their household has a medical condition that requires significant additional water use; (2) Social tariffs – in certain circumstances, companies can reduce charges for individuals who would otherwise have difficulty paying their water bill in full. In developing such charges English water companies must have regard to the UK Government's guidance on social tariffs. Welsh water companies must have regard to the social tariff guidance issued by the Welsh Government; and (3) Concessionary schemes for community groups for surface water drainage charges – companies that charge for surface water drainage on a site area basis may offer concessionary schemes for certain community groups. In developing such schemes English water companies must have regard to the UK Government's guidance on concessionary schemes.

<sup>18</sup> See section 43.

Meter-based charging can provide effective price signals to retailers and business customers about the water that they use and provide an incentive to use water efficiently. Where retailers and/or businesses receive a meter-based charge we expect the charge to reflect the long-run costs associated with providing the service and the cost of the water to be recovered primarily through the volumetric charge. Wholesalers and retailers also have a duty to promote the efficient use of water by their customers.<sup>19</sup> We are also open to considering wholesale charging rules that will allow for the reduction of charges to recognise retailers taking steps for the purpose of reducing or managing water consumption or the discharge of matter from premises; or retailers taking steps for the purpose of reducing the volume of surface water entering public sewers or the rate at which it does so. Meter based charging should ensure that wholesale water charges provide appropriate reduction to retailers who help reduce or manage water consumption, however, additional measures may be required for wastewater or surface water discharge.<sup>20</sup>

We have identified that there are some parts of the water and wastewater value chains where introducing markets may provide the significant benefits – sludge treatment and disposal and water resources. We consider that greater use of markets in these areas will generate benefits for the environment, for example through more efficient use of water resources or the generation of renewable energy from bio-resources. In looking to develop these markets we are looking to promote long-term thinking in the water industry and encourage the sustainable management and use of water resources.<sup>21</sup>

### **2.1.3 Stable and predictable**

The UK Government's [Charging guidance to Ofwat](#) highlights that stable and predictable water bills are valued and that this is a priority for the UK Government. It notes, for example, that there should be an expectation that customers should not face disproportionate changes in charges year-to-year where usage does not change markedly.

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<sup>19</sup> Recognising that new entrant WSSL licensees do not have this obligation - see [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/508326/wssl-licence-conditions-2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508326/wssl-licence-conditions-2016.pdf).

<sup>20</sup> Section 66E(2) of the Water Industry Act 1991 could provide an appropriate mechanism by which this could be done.

<sup>21</sup> For more information on promoting effective markets see: [Towards Water 2020 – policy issues: promoting markets](#).

## Promoting stable charges

Ensuring wholesalers fully understand their costs and cost drivers, and that their charges suitably reflect the underlying long-run costs helps ensure that wholesale charges do not change markedly from one year to the next. And, we are proposing a rule that will require wholesale charges to reflect long-run costs. In setting this requirement we recognise that not all wholesale charges may be fully cost reflective at this time. We therefore expect that wholesalers will, over time, improve their understanding of their costs and cost drivers, and that as a result improved cost reflectively will be achieved. We recognise that one consequence of this is that some wholesale charges may need to change, potentially significantly. Where this occurs, our rules will require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans.

We have also proposed that companies prepare, as part of their Board assurance process, a proportionate impact assessment if the bills faced by retailers (as a whole or in groups) are expected to increase by more than 5% from the previous year. And, given that wholesale charges typically represent around 90% of the costs ultimately faced by a business, we also expect wholesalers to consider the potential impact of these changes on business customers – see below for more information.

## Predictability of charges

Wholesale charges need to be communicated in a way that allows retailers to have a reasonable idea of the services available and the cost of those services.

Transparency in wholesale charges will therefore put pressure on wholesalers to better understand their own costs and cost drivers. This should also ensure that wholesale charges increasingly reflect long-run costs (see discussion above).

The timely production of wholesale charges will also facilitate a level playing field for retailers in competitive retail markets by providing sufficient time for retailers to question the charges that are being proposed by a wholesaler, develop their (retail) charging strategy and to engage with their customers. We are therefore proposing to set a requirement for final wholesale charges to be published at least 11 weeks before the start of the period in relation to which they apply<sup>22</sup> (and for indicative

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<sup>22</sup> We assume that a charging year will remain as a year commencing from 1 April, not least as the processes that have been designed by MOSL (for retail market opening in England) have been aligned to the April – March timeframe.

wholesale charges to be published at least 3 months before final wholesale charges are published – see chapter 3 for more information).

### **2.1.4 Transparent and customer-focused**

The UK Government's [Charging guidance to Ofwat](#) highlights that wholesale charges need to be transparent, appropriately simple and be presented in a way that is easy to understand. How we have looked to ensure transparent and customer-focused charges is discussed further below.

#### **Transparency of wholesale charges**

Ensuring wholesale charges are transparent will be key to ensuring the development of an effective competitive retail business market. In particular, transparency of these charges will encourage retailers to look closely at wholesalers' charges and will put pressure on wholesalers to better understand their own costs and cost drivers (and potentially reduce their wholesale charges). This is why we are proposing a rule that will require wholesalers to be transparent in the services they offer and in the charges that they set. We are also proposing rules that will require wholesalers to provide information to retailers in a timely manner.

#### **Customer focused**

As mentioned, wholesale charges typically represent around 90% of the costs ultimately faced by business customer. As such, we do not consider it appropriate for charges set by wholesalers (for retailers) to be set in isolation of business customers.

We are therefore proposing (recognising that there may be no direct relationship between a wholesaler and business customers in the competitive business customer retail market) that wholesalers engage with business customers (as a whole or in groups) when developing their wholesale charges. It will, however, be up to wholesalers to decide the appropriate level of consultation and feed this into their decisions on wholesale charges, including with respect to any transition plans and their communication with customers and/or customer groups. As part of this, wholesalers should consider whether and how it might be appropriate to seek additional challenge and assurance from Customer Challenge Groups.

We also intend to set requirements for wholesale charges to be published in a transparent way.

## 2.2 Welsh Government's consultation on charging guidance

In August 2015, the Welsh Government issued its [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#). The purpose of that consultation was to ensure that our charging rules reflect the Welsh Government's policy priorities for the water sector.

The Welsh Government drafted its guidance within the context of two key themes of the Water Strategy for Wales:

- delivering excellent services to customers; and
- water for nature, people and business.

In this document the Welsh Government notes that it will be up to us to balance the long-term needs of a sustainable and resilient environment with the need to ensure that there are sufficient, reliable water resources with incentives that provide the right balance between rewards and penalties in the context of Welsh Government priorities and circumstances in Wales.

How we have met the two key themes identified by the Welsh Government with respect to our wholesale charging rules is outlined below. While separate consideration of the Welsh Government's consultation and the UK Government's charging guidance is appropriate, there is sufficient commonality between the material that they have published that we consider that issuing draft wholesale charging rules for wholesalers operating wholly or mainly in Wales and for those wholly or mainly operating in England is appropriate at this time (albeit with appropriate changes where appropriate).<sup>23</sup>

### 2.2.1 Delivering excellent services to customers

The Welsh Government's [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) notes that to deliver excellent services to customers there is a need for:

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<sup>23</sup> See discussion in section 3.7 where we propose, for example, that in Wales, where the level of competition is to remain at current levels, we do not consider that it would be proportionate to require that NAVs that are wholly or fully in Wales to develop and publish wholesale charges. They would, however, still have to meet their obligations under general competition law.

- water companies to have a sound understanding of customer needs and a strong voice for consumer representation;
- water companies to undertake proportionate assessment of the impacts of any significant incidence (burden) effects on customers as a whole, or on groups of customers, and act on the results;
- Ofwat should take a proportionate approach to regulation;
- Ofwat should take account of the affordability issues specific to Wales and be supportive of proposals for charges which are both fair and protect vulnerable and low income groups; and
- the Welsh language not to be treated less favourably, with companies expected to publish their charges scheme bilingually.

We consider each of these points below.

### **A sound understanding of customer needs**

Our approach to regulation requires wholesalers and retailers to understand their customers and deliver outcomes over the long term. This means wholesalers and retailers finding out what matters most to their customers and delivering this.

We expect wholesalers and retailers to understand the needs of all their customers and any circumstances which might make their customers vulnerable. This requires more diverse approaches to understanding customers' priorities, needs, requirements and behaviours. This understanding should help drive the delivery of resilient services now and in the longer term.

Given the above, we do not consider it appropriate for charges set by wholesalers wholly or mainly in Wales to be set in isolation of business customers (even where there may be no direct relationship between a wholesaler and business customers in the competitive business customer retail market). We expect wholesalers to consult extensively, including with retailers and business customers (as a whole or in groups) when developing their wholesale charges. It will, however, be up to the wholesalers operating wholly or mainly in Wales to decide the appropriate level of consultation and feed this into their decisions on wholesale charges, including with respect to any transition plans and their communication with customers and/or customer groups.<sup>24</sup> As part of this, wholesalers should consider whether and how it

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<sup>24</sup> The large water companies that are operating wholly or mainly in Wales are Dee Valley Water and Dŵr Cymru (Welsh Water). In addition, Albion Water (Shotton) Ltd is a new entrant company (a NAV) that holds an appointment as a water undertaker in Wales. All these companies will be covered by our wholesale charging rules.

might be appropriate to seek additional challenge and assurance from Customer Challenge Groups.

We also intend to set requirements for wholesale charges to be published on a wholesaler's website in a transparent way.

### **Proportionate assessment of the impacts of any 'incidence effects'**

Ensuring wholesalers fully understand their costs and their cost drivers and that their charges suitably reflect underlying long-run costs helps ensure that wholesale charges do not change markedly from one year to the next. And, consistent with this we are proposing a rule that will require wholesale that are wholly or mainly in Wales to set wholesale charges that reflect long-run costs. In setting this requirement we recognise that not all wholesale charges may be fully cost reflective at this time. We therefore expect that wholesalers will, over time, improve their understanding of their costs and cost drivers and that improved cost reflectivity will be achieved. And, as a consequence, we recognise that charges may need to change, potentially significantly. Where this occurs, our rules will require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans.

We have also proposed that companies prepare, as part of their Board assurance process, a proportionate impact assessment when they expect that retailers (as a whole or in groups) will face bill increases of more than 5% from the previous year. And, given that wholesale charges typically represent around 90% of the costs ultimately faced by a business, we also expect (as discussed above) the wholesaler to consider the potential incidence effects of changes in their charges on businesses and develop sensible transition plans.

### **A proportionate approach to regulation**

We have adopted a risk-based approach to regulation to make sure that we regulate in line with the Better Regulation principles, and take appropriate steps to minimise the regulatory burden we place on the companies we regulate. By focusing our activities on the most significant risks to consumers, we can also ensure that regulatory scrutiny and burdens are targeted appropriately and proportionate to the risks we have identified.

## **Supportive of proposals for charges which are both fair and protect vulnerable and low income groups**

Our price controls, including those for wholesale activities, seek to protect customers (including certain groups of customers who are in need of protection) by, among other things setting revenue limits that reflect the efficient costs of delivering that performance. Licence condition B also requires wholesalers to levy charges in a way best calculated to comply with our price controls. This provides an overall safeguard on charges set by them.

The legislative framework also makes allowances for vulnerable groups to receive special protections<sup>25</sup> in relation to charges made by both retailers and wholesalers. The Flood and Water Management Act (2010) establishes the framework for concessionary surface water drainage charges to community groups.<sup>26</sup> And, reflecting this, our wholesale charges rules require wholesalers to clearly set out the terms for these concessionary charges and to provide retailers with the same discounts that are offered to the wholesaler's own customers.

Affordability will also be ensured through companies preparing, as part of their Board assurance process, a proportionate impact assessment if the bills faced by retailers (as a whole or in groups) and businesses are expected to increase by more than 5% from the previous year – see earlier discussion. This is why where significant changes to wholesale charges are required, our rules require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans.

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<sup>25</sup> Allowance for vulnerable groups include: (1) WaterSure – this is a scheme that caps the water bills of metered customers who are in receipt of certain benefits, if they have a large family, or if a member of their household has a medical condition that requires significant additional water use; (2) Social tariffs – in certain circumstances, companies can reduce charges for individuals who would otherwise have difficulty paying their water bill in full. In developing such charges English water companies must have regard to the UK Government's guidance on social tariffs. Welsh water companies must have regard to the social tariff guidance issued by the Welsh Government; and (3) Concessionary schemes for community groups for surface water drainage charges – companies that charge for surface water drainage on a site area basis may offer concessionary schemes for certain community groups. In developing such schemes English water companies must have regard to the UK Government's guidance on concessionary schemes.

<sup>26</sup> See section 43.

Wholesalers wholly or mainly in Wales must also ensure that their charges comply with competition law and we can investigate concerns should we consider it appropriate to do so.

## **Publications in Welsh language**

As we regulate the water sector in England and Wales, we regularly publish information in the Welsh language. Our wholesale charging rules will be published in Welsh and English.

### **2.2.2 Water for nature, people and business**

The Welsh Government's [Consultation on Charging Guidance to Ofwat \(the economic regulator of the water sector\)](#) notes that to ensure water for nature, people and business there is a need for:

- Ofwat to have regard to its duties and to ensure companies have a range of measures in place to manage resources in a sustainable way and that it carries out its duties in manner that will contribute to the achievement of sustainable development;
- Ofwat to ensure that a proportionate assessment of changes to its regulatory framework for the water and sewerage sector has been carried out; and
- no move to de-averaging of network costs although there in some cases it may be beneficial to use targeted prices signals to improve recognition of environmental costs.

Each of these issues is considered below.

### **Managing resources in a sustainable way**

We need to ensure that the water sector is resilient, efficient and taking a long-term approach. Meter-based charging can provide effective price signals to retailers and business customers about the water that they use and provide an incentive to use water efficiently. Where retailers and/or businesses receive a meter-based charge we expect the charge to reflect the long-run costs associated with providing the service and the cost of the water to be recovered primarily through the volumetric charge. We are also open to considering wholesale charging rules that will allow for the reduction of charges to recognise retailers taking steps for the purpose of reducing or managing water consumption or the discharge of matter from premises; or retailers taking steps for the purpose of reducing the volume of surface water entering public sewers or the rate at which it does so. Meter based charging should

ensure that wholesale water charges provide appropriate reduction to retailers who help reduce or manage water consumption, however, additional measures may be required for wastewater or surface water discharge.<sup>27</sup>

Wholesalers and retailers also have a duty to promote the efficient use of water by their customers.<sup>28</sup>

## **Ensuring a proportionate assessment of changes**

We are working to foster a more mature relationship with wholesalers and retailers. We want to have open discussions about existing and emerging risks, the steps that wholesalers and retailers are taking to manage them, and our decisions on the actions we need to take.

When considering any substantive changes in regulatory direction that are designed to drive changes we work with the industry to develop a proportionate assessment of the impact of this change on customers as a whole and on different customer groups and take action in light of that assessment.

We also look to ensure that where reasonably possible, changes are handled carefully to ensure that all customers continue to face predictable and stable bills. This means, among other things, that companies prepare, as part of their Board assurance process, a proportionate impact assessment if the bills faced by retailers (as a whole or in groups) are expected to increase by more than 5% from the previous year. And, given that wholesale charges typically represent around 90% of the costs ultimately faced by a business, we also expect wholesalers to consider the potential impact of these changes on business customers. Our rules will also require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans.

## **No move to de-averaging of network costs and the use of targeted prices signals to improve recognition of environmental costs**

Our wholesale charging rules do not require wholesalers wholly or mainly in Wales to set wholesale charges on the basis of de-averaged network costs. However, it is

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<sup>27</sup> Section 66E(2) of the Water Industry Act 1991 could provide an appropriate mechanism by which this could be done.

<sup>28</sup> Recognising that new entrant WSSL licensees do not have this obligation - see [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/508326/wssl-licence-conditions-2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508326/wssl-licence-conditions-2016.pdf).

important that wholesalers wholly or mainly in Wales have good quality information about their own costs, including in relation to different wholesale service and different geographic areas. This is important if they are to optimise their network configuration and usage, and thereby achieve efficiencies that will benefit all customers.

We also consider it reasonable that wholesalers wholly or mainly in Wales to move towards wholesale prices that reflect the long-term costs. This means that we expect wholesalers wholly or mainly in Wales to carefully consider their costs and cost drivers when setting their charges, and that as they obtain more accurate cost information on the services that they provide they will set charges that more accurately the costs incurred in providing that service.

In setting this requirement we recognise that not all wholesale charges may be fully cost reflective at this time. We therefore expect that wholesalers wholly or mainly in Wales will, over time, improve their understanding of their costs and cost drivers and that improved cost reflectively will be achieved. As a consequence, we recognise that charges may need to change. Where this occurs, our rules will require that wholesalers wholly or mainly in Wales will need to effectively communicate with retailers and business customers to develop transitional plans. In addition, as per the discussion above, we will require that companies prepare, as part of their Board assurance process, a proportionate impact assessment if the bills faced by retailers (as a whole or in groups) are expected to increase by more than 5% from the previous year. And, as wholesale charges typically represent around 90% of the costs ultimately faced by a business, we also expect wholesalers to consider the potential impact of changes in their charges on these stakeholders.

We also recognise that our proposal to require wholesalers wholly or mainly in England to separate out wholesale wastewater charges by 2020 (see chapter 3) may not be appropriate for wholesalers wholly or mainly in Wales, as the scope for retail competition in Wales will remain at current levels – which means that businesses, charities and public sector in Wales will not be able to choose their supplier of wastewater services. The potential benefits of separating out wholesale wastewater charges in Wales to help potential market entrants is therefore more limited. We are therefore not proposing that wholesalers wholly or mainly in Wales be required to separate out wholesale wastewater charges.

Wholesalers wholly or mainly in Wales will however need to explain what wholesale services the retailers are paying for in their wholesale charges. This will require that wholesalers effectively communicate with retailers and business customers to develop sensible transition plans. This approach will also improve transparency and will improve trust and confidence in the sector.

Wholesalers wholly or mainly in Wales must also ensure that their charges comply with their licence obligations and their obligations under competition law, recognising that we can investigate concerns should we consider it appropriate to do so.

We also recognise that customers value bill stability and that they should not face disproportionate changes in charges year-to-year where usage does not change markedly. That is why we have proposed that companies, as part of their Board assurance process, prepare a proportionate impact assessment if they expect retailers (as a whole or in groups) or businesses (as a whole or in groups) to increase by more than 5% from the previous year – see earlier discussion.

In outlining the above we recognise that the Welsh Government has yet to issue its final charging guidance to us, and that other issues may emerge. We will therefore consider whether it is appropriate to amend our wholesale charging rules when the Welsh Government issues its final charging guidance to us.

## **2.3 Consultation questions**

Q1 Do you have any specific views on the draft wholesale charging rules included in appendix 1? Are there additional rules that we should include in the future?

Q2 Do you agree with our proposed threshold (5%) for significant bill increases, above which wholesalers will be required to undertake an impact assessment for changes to charges?

### 3. Key policy issues

This chapter outlines the key policy issues we have considered in developing our draft wholesale charging rules for England and Wales. Specifically, this chapter considers:

- standardisation of the structure of wholesale charges (section 3.1);
- timing of the publication of wholesale charges (section 3.2);
- transparency of wastewater charges (section 3.3);
- completeness of wholesale charges (section 3.4);
- transparency of special agreements (section 3.5);
- back billing (section 3.6); and
- small companies (NAVs and Cholderton and District Water Company Limited) – section 3.7.

In developing our draft rules we recognise that the extent of retail competition currently in Wales will remain as present.<sup>29</sup> We nonetheless consider that these draft rules are proportionate for wholesalers in Wales as:

- we require<sup>30</sup> large wholesalers that are wholly or mainly in Wales to publish their charges to demonstrate compliance with the wholesale price controls that we set at PR14<sup>31</sup>;
- our draft rules will help ensure that wholesalers better understand their costs and cost drivers, and that retailers operating in Wales are clear what they are paying for. This will ensure that business and residential customers in Wales will benefit, whether they are part of a competitive market or a monopolistic one; and
- beyond the competitive retail market our new wholesale charging rules will bring benefits in terms of greater transparency of charges and will improve the accountability of wholesalers for their charges and the impact they have on retailers and on end customers

In outlining our proposals we have drawn on information received from previous consultations that have considered wholesale issues, including [‘Wholesale and retail](#)

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<sup>29</sup> Businesses, charities and public sector organisations of wholesalers whose areas are wholly or mainly in Wales will therefore continue to be able to choose their retailer for water (but not wastewater services) if their premises are supplied with at least 50 mega litres of water a year.

<sup>30</sup> In accordance with Condition B (Charges) of their appointments (‘licences’).

<sup>31</sup> English companies also need to publish their charges to demonstrate compliance with the wholesale price controls that we set at PR14.

charges – a consultation and Consultation on charges scheme rules for 2016-17 and future developments.

### 3.1 Standardisation of the structure of wholesale charges

There are currently considerable differences in the structure of charges between wholesalers and increased standardisation of wholesale charges could help reduce complexity in the business retail market. This benefit would be particularly apparent for retailers operating nationally (including those who wish to operate in the competitive part of the market for business customers in Wales). Reduced complexity would also help reduce barriers to entry and therefore increase choice, delivering greater benefits for customers in the competitive parts of the retail market.

However, as outlined in responses to 'Wholesale and retail charges – a consultation'<sup>32</sup>, increased standardisation of wholesale charging structures could limit innovation and produce large incidence effects. It could also limit the scope for the tailoring of wholesale charges to better reflect regional needs, such as water scarcity.

In developing our draft wholesale charging rules our preference has been to see some standardisation of the structure of wholesale charges but for us not to design and specify companies' tariffs. We consider that there are two broad approaches by which this could be achieved, one is Ofwat-led, the other is industry led.

Consistent with our strategy – being clear on the expectations companies face, and enabling and incentivising them to deliver against those in efficient and innovative ways – we are looking to introduce a rule that will require wholesalers wholly or mainly in England and wholly or mainly in Wales to consider general charging principles when setting their charges<sup>33</sup>. We are not proposing to introduce any other

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<sup>32</sup> See the appendix in the document available at: [http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/competition/review/pap\\_con20140117charging.pdf?download=Download](http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/competition/review/pap_con20140117charging.pdf?download=Download).

<sup>33</sup> The high-level principles that we have proposed are consistent with the key objectives outlined in the UK Government's charging guidance to us. As the Welsh Government has yet to issue its final charging guidance to us, we will amend our wholesale charging rules should it be appropriate to do so when it does. We note that it will be up to wholesalers to determine the level of stakeholder engagement that they undertake when considering these issues as well as how they may trade-off (if required) the different aspects of this particular rule. However, we would expect that an appropriate level of stakeholder engagement would form part of a wholesaler's overall approach.

rules associated with wholesale charge harmonisation at this time.<sup>34</sup> We therefore encourage companies to give further thought to how they could look to ensure greater wholesale charge standardisation of structures (including by working through an appropriate industry body).

### **3.2 Timing of the publication of wholesale charges**

The timing of the publication of wholesale charges is key if we want to ensure a level playing field and the development of effective competition for business retail in England and the part of the business retail market that is contestable in Wales.

If wholesale charging information is published too close to the date those charges have effect (which is typically April) it will limit a retailer's ability to:

- challenge the wholesale charges being proposed by their wholesaler;
- plan for the year ahead, including with respect to the development of its retail pricing proposals; and
- effectively engage with and advertise to its customers.

In October 2015, we issued an information notice that required wholesalers to publish their 2016-17 wholesale charges scheme no later than 14 January 2016.<sup>35</sup> This January requirement provided an opportunity for a wholesaler to consider November inflation data – Price controls for wholesale activities are linked to the November Retail Price Index (RPI) – which is published in mid-December.

As we are keen to see a level playing field in the retail business market in England and in the part of the retail business market that is contestable in Wales, we consider that requiring wholesalers to publish their final wholesale charges at least 11 weeks before the start of the period in relation to which the charges will be imposed is appropriate. And, we have proposed a rule that does this. We are also proposing that wholesalers to publish indicative primary wholesale charges at least 3 months before they issue their final wholesale charges.

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<sup>34</sup> The general charging principles that we are proposing to introduce in our wholesale charging rules have also been proposed in our connection charging rules.

<sup>35</sup> See: [IN 15/13 "Publication of wholesale charges and provision of information on special agreement"](#).

Our proposed approach to the timing of the publication of information on wholesale charges looks to maximise a retailer's ability to:

- challenge the wholesale charges being proposed by their wholesaler;
- plan for the year ahead, including with respect to the development of its retail pricing proposals; and
- effectively engage with and advertise to its customers.

Our proposals are discussed in more detail below.

### **3.2.1 Timing of the publication of indicative wholesale charges**

In developing our proposals on the appropriate timing of the publication of indicative wholesale charges we have drawn on the evidence received from our [Consultation on charges scheme rules for 2016-17 and future developments](#). In that consultation we sought views on our early thinking on the timing of indicative charges – a requirement that wholesalers wholly or mainly in England and wholesalers wholly or mainly in Wales publish indicative wholesale charges in July (for the following charging year) and in October (which companies would not be able to revise apart from the updating to reflect the November RPI).

The proposals on indicative charges that we are proposing in this consultation are explored in more detail below. In developing these proposals we are aware that the systems that the Market Operator Services Limited (MOSL) has designed for market opening have been aligned to the April – March charging year. However, our charging rules are intended to provide sufficient flexibility to apply regardless of the definition of the charging year or proposals to revise charges during the year.

#### **Notification of potential significant changes six months before final charges**

We do not consider (as per our previous consultation) that requiring wholesalers wholly or mainly in England and wholly or mainly in Wales to publish indicative charges in July is proportionate, because it is not necessary to require publication at a specific time of year. But, if a wholesaler intends to significantly alter its approach to charging, or intends to introduce new charges, it should know this at least six months before issuing its final wholesale charges. We have therefore proposed that wholesalers notify stakeholders (retailers and business customers) six months before they issue their final wholesale charges if they are considering significant changes to their charges (even where earlier engagement may have highlighted that this was the case).

In proposing this requirement we appreciate that wholesalers may not have fully concluded on their charging strategy.<sup>36</sup> But, if significant reform is being considered we do expect that wholesalers would have commenced their engagement with retailers (and business customers) well before this time; with the absence of such suggesting significant scope for improvement.

We do not consider that our proposal will impose a significant new burden on wholesalers. Rather it looks to ensure greater transparency in and formalisation of a process that wholesalers should already be following. Put simply, this can be considered a 'heads-up' to the sector. As such, the information that a wholesaler publishes as part of any notification need not be as comprehensive as either their indicative charges (see below) and/or any statement of significant changes (see chapter 4).

### **Indicative charges 3 months before final charges**

Having indicative charges information sufficiently early will be key to helping retailers develop charges and begin marketing to potential customers. Our proposal for indicative wholesale charges is that wholesalers wholly or mainly in England and wholly or mainly in Wales will publish indicative wholesale charges information three months before they issue their final charges. However, wholesalers will only need to publish indicative charges for primary wholesale charges – a burden that is no higher than it needs to be to meet our objectives.

Our proposal will also allow wholesalers wholly or mainly in England and wholly or mainly in Wales to update their indicative charges as necessary<sup>37</sup> when setting their final wholesale charges. This approach reduces the scope for wholesalers to be adversely impacted by the wholesale revenue forecasting incentive mechanism for using inaccurate data to develop their wholesale charges.<sup>38</sup>

We are also proposing that indicative charges should be published with Board assurance. This assurance will help ensure that any underlying data used to develop indicative (and final) charges is accurate both in terms of ensuring their continued compliance with their licence obligations and their obligations under competition law,

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<sup>36</sup> Wholesalers should still nonetheless have sufficient understanding of their costs and cost drivers to enable them to put forward indicative charges at this time.

<sup>37</sup> This means that wholesalers will not be limited to just updating for November RPI as was suggested in our [Consultation on charges scheme rules for 2016-17 and future developments](#).

<sup>38</sup> The use of inaccurate data could have resulted in over or under recovery of revenue that was outside acceptable bands.

particularly given that many of them may be operating in both the provision of wholesale services and the retail market for those same services.

While our proposals will allow indicative wholesale charges to vary between the issuing of their indicative charges and final charges, in the event that there are significant changes to a wholesaler's primary charges between these dates we expect wholesalers to publish, as part of their Board assurance – see chapter 4 – a statement that outlines the reason for these changes and why this was not anticipated and/or mitigated. The quality of this assurance will feed into our broader assessments of the quality of company information, and their assurance of that information in our company monitoring framework.

We consider that our proposal strikes the appropriate balance between ensuring wholesalers can produce accurate final charges and retailers having confidence in wholesalers' indicative charges.

### **3.3 Transparency in wholesale wastewater charges**

Wastewater wholesale charges cover wholesale services for the treatment of trade effluent, foul water, highway drainage and surface water drainage. Typically foul water, highway drainage and surface water drainage charges are aggregated within bills faced by consumers, thereby obscuring the costs associated with each service. We consider that retailers (and ultimately business and residential customers) would benefit from greater transparency in wholesale wastewater charges.

Separating out and ensuring transparency in wholesale wastewater charges will help build trust and will encourage wholesalers to carefully consider the costs and cost drivers associated with providing these services. Consequently, some wholesale wastewater charges may need to change, potentially significantly. Where this occurs, our rules will require that wholesalers effectively communicate with retailers and customers to develop sensible transition plans.

We also consider that separating out and ensuring transparency in wholesale wastewater charges will help potential entrants to the wastewater retail market in England to identify opportunities. It will also allow retailers an opportunity to better understand (and compare) the costs of the services being offered by wholesalers.<sup>39</sup>

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<sup>39</sup> If this transparency is reflected in customer bills we consider it would also allow residential and business customers to respond more directly to any price signals embedded in the charges. This

Further, it will enable third party service providers better to understand where they may be able to offer services to wholesalers that would enable efficiencies or more innovative approaches.

For the reasons outlined above – helping to build trust, encouraging wholesalers to consider their costs and cost drivers, and allowing retailers (including potential new entrants) an opportunity to better understand (and compare) the costs associated with the services being provided – we consider that a rule requiring the separation of and transparency in wholesale wastewater charges for wholesalers wholly or mainly in England has merit. In time we therefore expect to see individual charges for trade effluent, foul water, highway drainage and surface water drainage charges in wholesale charging schemes published by wholesalers wholly or mainly in England.

However, we recognise that not all wholesalers wholly or mainly in England will have reporting and billing systems that are sufficient to appropriately disaggregate these charges in the immediate future, including considering the appropriate allocation of costs and the potential impact of these changes on retailers and customers).

We are therefore proposing a rule that will require wholesalers wholly or mainly in England to clearly identify and separate out the different wastewater services charges that they offer to all retailers in England by April 2020. Wholesalers wholly or mainly in England are therefore encouraged to start considering how they will separate out their charges for the treatment of trade effluent, foul water, highway drainage and surface water drainage. And, while separating out of the different wastewater services charges may not occur immediately, we will be requiring wholesalers to ensure there is transparency in the charges contained within their wastewater charges. This transparency will ensure that retailers are clear what they are paying for and can respond appropriately, including by putting more pressure on wholesalers to better understand their own costs and cost drivers.

As discussed in chapter 2, requiring wholesalers wholly or mainly in Wales to separate out the different wastewater services charges that they offer may not be appropriate as the scope for retail competition in Wales will remain at current levels – which means that businesses, charities and public sector in Wales will not be able to choose their supplier of wastewater services. The potential benefits of separating out wholesale wastewater charges in Wales to help potential market entrants is therefore

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could have a positive impact on the environment. Furthermore it would allow retailers to have an informed discussion with their customers on the ways they may be able to reduce their bills.

more limited. We are therefore not proposing to require that wholesalers wholly or mainly in Wales separate out wholesale wastewater charges.

We are, however, proposing that wholesalers wholly or mainly in Wales will need to explain what wholesale services the retailers are paying for in the wholesale charges. This would require water companies to decide how to communicate these and how to engage with customers. This will improve transparency and will improve trust and confidence in the sector.

Wholesalers wholly or mainly in Wales must also ensure that their charges comply with their licence obligations and their obligations under competition law, recognising that we can investigate concerns should we consider it appropriate to do so.

### **3.4 Completeness of wholesale charges**

As discussed in chapter 1, we require wholesalers to publish their charges to demonstrate compliance with our wholesale price controls. Wholesalers publish these charges in documents called “wholesale charges publications” or “wholesale charges schemes”.

We consider that wholesale charging information should be complete. Completeness of information will help ensure transparency and encourage wholesalers to better understand both the costs that they incur in providing them and their cost drivers. It will also enable third parties to offer products and services to wholesalers where they believe these can drive efficiency or new and different ways of doing things. It will further ensure that retailers are clear what they are paying for and can respond appropriately. As such completeness can facilitate competition in the business retail market (where it is permitted) which in turn can encourage innovation, for example through the development of retail offerings that include water efficiency services or incentivise better wastewater management.

We consider that requiring all primary and non-primary charges to be published could lead to significantly higher regulatory costs.<sup>40</sup> In addition, it would be difficult for

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<sup>40</sup> Primary charges are the charges that typically involve meter based annual charges and/or volumetric charges for the provision of supplies of water or sewerage services, while non-primary charges typically reflect the charges for services provided by wholesalers directly to the customers. Examples of non-primary charges include charges for disconnection, meter testing, provision of fire hydrants and pressure tests.

wholesalers to set charges for bespoke wholesale services – those services that tend to be unique to particulate circumstances – in advance.<sup>41</sup>

However, we do see merit in including within our wholesale charging rules a requirement for wholesalers to publish, in addition to primary wholesale charges, the charges associated with a number of the more common non-primary charges.

Having considered the wholesale charges published by a number of wholesalers, we consider that, at a minimum, the non-primary charges that should be published (even where the associated charge is zero or is not applicable) are:

- the replacement of lead service pipes;
- the provision and maintenance of fire hydrants;
- damage to apparatus;
- the carrying out of inspections to ascertain whether any provision in or made or having the effect on the Water Industry Act 1991 with respect to any water fittings or with respect to the waste or misuse of water is being or has been contravened;
- site inspections;
- the provision and use of standpipes;
- the testing of meters; and
- the disconnection of a service pipe (or otherwise cutting off a supply of water) to any premises and the reconnection of such supplies to a water main.

In proposing this rule we recognise that there may be situations where specifying these charges in advance will be challenging. We are therefore proposing that where a charge cannot be outlined in advance that wholesalers publish the methodology that they will use to calculate those charges.

Wholesalers are free (and are encouraged) to publish other non-primary charges, and we note that the Wholesale Contract<sup>42</sup> will only require retailers to pay the charges ‘calculated and payable in accordance with the Wholesale-Retail Code and the Wholesale Tariffs Document and/or as set out on the Special Agreements

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<sup>41</sup> For example, the cost to replace lead service pipes will depend on where those pipes are located and the length of the pipe that needs to be replaced.

<sup>42</sup> The contract that constitutes (i) a Section 66D Agreement, (ii) a Section 117E Agreement, or (iii) both a Section 66D Agreement and a Section 117E Agreement, and which, in each case, refers to and incorporates the terms and conditions set out in the Wholesale-Retail Code.

Register'. Retailers will therefore only be liable for other charges if there is a specific statutory requirement or a separate individual agreement.<sup>43</sup>

### 3.4.1 Concessionary drainage charges

The Flood and Water Management Act 2010 gives wholesalers the power to offer concessionary surface water drainage charges to community groups.<sup>44</sup> This Act does not, however, prescribe which community groups must be included in any scheme. That is a decision for the wholesaler, as long as those benefitting are 'bodies that in [its] opinion provide benefit to the local community'.

The UK Government's [Charging guidance to Ofwat](#) also states:

Following the opening of the new retail market, it is expected that in cases where community groups switch to a licensee or are transferred as part of an exit the discount will be applied to the wholesale charge that is passed to the licensee. It is expected that licensees will help community groups to be aware of and to obtain these discounts, so that they still benefit from these while participating in the competitive market.

This means that for a retailer to be able to provide information on and/or pass through any drainage discounts it needs to know what wholesale discounted charge will apply. We are therefore proposing to introduce a rule that will require wholesalers to:

- state what concessionary surface water drainage discounts are available to retailers; and
- provide those concessionary surface water drainage discounts in a fair reasonable and non-discriminatory way, including in particular as between their own downstream retailers and independent retailers.

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<sup>43</sup> Irrespective of where this information is placed, wholesalers should ensure that it is clear, transparent and simple.

<sup>44</sup> Section 43.

### 3.5 Transparency of special agreements

The Water Industry Act 1991 allows appointed companies<sup>45</sup>, instead of charging in accordance with a charges scheme, to enter into a special agreement. This agreement will specify the charges for supplies of water or sewerage services to business premises. These charges could be different to those set out in a charges scheme (assuming that they comply with all the relevant legal requirements).

From April 2017, all business customers of appointed companies whose areas are wholly or mainly in England, including those on special agreements, will be part of a contestable retail market (as will all business customers of appointed companies whose areas are wholly or mainly in Wales that use more than 50 mega litres of water a year). To ensure a level playing field for businesses with special agreements, a certain level of transparency on the price and non-price terms of such agreements will be required.

There is an obligation, set out in section 142(6A) of the Water Industry Act 1991, for appointed companies to notify us of the provisions of any new special agreement. We are required to enter on our statutory register (and therefore put in the public domain) such information about those new agreements as we think fit.

Services provided by special agreements are contestable along with the wider retail services in the business retail market. Where there are special agreements in place, the changes made by the Water Act 2014 will require us to make wholesale charging rules that require the wholesale business of appointed companies to impose on retailers only such charges as would enable the retailer to charge for those services at the same rate or rates as would have applied under the special agreement.

We are therefore proposing that where an appointed company has entered into a special agreement it must provide information about the wholesale charge component of its charges, and that this information should be made publicly available. As part of this wholesalers must clearly demonstrate the level of discounts that are possible at different trigger points of any agreement.

When wholesalers are calculating the wholesale component of the charge that has been agreed under the special agreement it will also be incumbent on them to ensure that they do so in a manner that is compliant with their obligations under

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<sup>45</sup> For these purposes, companies holding appointments as water and/or sewerage undertakers.

competition law and their licence conditions (such as the prohibition on undue discrimination or preference in Condition R).

### 3.6 Back-billing

A back bill is a ‘catch-up’ bill that occurs when a wholesaler (or retailer) identifies that a retailer (or customer) hasn’t been correctly charged for their water.

We are looking to ensure that there are consistent rules around back billing for wholesalers and retailers in the new market in England and in the part of the market that is contestable in Wales.<sup>46</sup>

Our [Customer Protection Code of Practice](#) looks to ensure that all eligible businesses<sup>47</sup> can only be back-billed up to a maximum of 16 months (in line with the settlement processes of the central systems that will administer that market). We have also suggested – in a recent decision document<sup>48</sup> – that this obligation should apply to wholesalers, and in May we published a [consultation document](#) in which we suggested that:

To appropriately protect customers in the market, we propose to insert a new condition in the IoAs requiring appointed companies to comply with the [Customer Protection Code of Practice] CPCoP.... [W]e propose to include a condition in the IoA that is substantively identical to the condition currently included in the WSSL standard conditions, simply amending ‘licensee’ to ‘appointee’. The condition would require all appointees to comply with the obligations of the CPCoP and would state that the process for modifying the CPCoP would be set out in the CPCoP.<sup>49</sup>

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<sup>46</sup> Inconsistent rules around back-billing could, for example, result in a wholesaler issuing a back-bill to a retailer for six years’ worth of water while the retailer would only be able to issue a back-bill for a maximum of 16 months’ worth of water. The difference in the respective revenues that could be collected by the wholesaler and the retailer could act as a disincentive for potential new entrants to enter the business retail market.

<sup>47</sup> See footnote 4.

<sup>48</sup> See this [decision document](#).

<sup>49</sup> Ofwat, Retail market opening - further changes to all instruments of appointment, May 2016, p.15.

By placing a condition into both the licences of all existing companies and all new retailers we could ensure that all wholesalers and retailers are covered by the obligations of the [CPCoP](#), including with respect to back billing.

However, there is a question about how to ensure consistent rules about the back-billing of retailers by wholesalers. A more appropriate approach to back-billing could therefore be to include a general obligation in either the licence, the Wholesale-Retail Code (WRC) or the wholesale charging rules.

We are aware that the Interim Code Panel (ICP) is considering a proposal to amend the WRC to ensure that there are consistent rules around back billing between wholesalers and retailers in the new market, consistent with the CPCoP (and we understand that this will be brought back to the August ICP meeting for decision). If the ICP agrees to that change then a wholesale charging rule may not be required. However, if the ICP does not support the change then we will have to consider whether a wholesale charging rule on back billing is required.

### **3.7 Small companies**

Small companies include NAVs<sup>50</sup> in England and Wales, and Cholderton and District Water Company Limited.

NAVs and Cholderton and District Water Company Limited were not subject to separate wholesale and retail price limits in PR14, reflecting their smaller size and the need for proportionate price control arrangements. Rather, NAVs are subject to a relative price cap (where their charges must be no higher than the previous incumbent's 'retail' charges) and Cholderton and District Water Company Limited is subject to a simplified revenue control.

To comply with business retail market opening in England, NAVs and Cholderton and District Water Company Limited will need to be able to offer clear and

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<sup>50</sup> A NAV is a new entrant company that holds an appointment as water and/or sewerage undertaker but most commonly serves sites ('insets') that have been (re)developed since privatisation. For example, a developer may choose to find an alternative to the existing water and/or sewerage undertaker to provide the necessary services. NAVs can supply water and/or sewerage services on an on-going basis. They can also get water from their own source, or buy it from another water undertaker; likewise they can either treat sewage themselves or agree to discharge it into another sewerage undertaker's sewers. However, generally NAVs have tended to provide 'retail' services as well as some 'wholesale' services that generally relate to the 'last mile' of on-site infrastructure and pipes that they lay for a developer.

transparent wholesale charges as this will facilitate competition. We therefore consider that it is proportionate to require small companies in England to develop and publish wholesale charges. These charges should be cost reflective and comply with competition law.

In Wales, where the level of competition is to remain at current levels, we do not consider that it would be proportionate to require that NAVs that are wholly or fully in Wales to develop and publish wholesale charges. However, the non-applicability of this requirement for NAVs that are wholly or fully in Wales does not exempt them from their obligations under general competition law.

Given the existing relative price control arrangements that NAVs in England are subject to, and the need for their end-tariffs for any individual site to be no worse off than the previous incumbent, we recognise that there is a question about the relationship with the wholesale charges of the adjacent incumbent.<sup>51</sup> We consider that NAVs in England will need to set their own wholesale charges and can see legitimate reasons why those wholesale charges might well be different from the adjacent incumbent. And, our charging rules will not prevent small companies in England from setting different wholesale charges. We welcome views from stakeholders on this proposed approach and any suggestions for future changes.

### **3.8 Consultation questions**

Q3 Do you agree with our proposal not to set rules requiring standardisation of wholesale charges at this point, but to consider this issue further, following market opening, taking account of any progress by industry to develop standardised charging structures and the benefits from that standardisation?

Q4 Do you consider that requiring wholesalers to provide an update on potentially significant changes to their wholesale charges six months before their final charges are published is appropriate? And, do you consider that requiring information on their primary indicative wholesale charges three months before any new charges are published is reasonable?

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<sup>51</sup> In the majority of cases where we have granted NAVs, these have been for unserved sites where customers are not present at the time of appointment. As such, the customers on these sites will not have paid previous charges to another wholesaler. However, where we have granted NAVs in circumstances where customers are present on the site (for example, via the consent criterion), then they will have paid charges to a previous supplier.

Q5 Do you agree that requiring company Board assurance for indicative primary wholesale charges is reasonable? And, where there are significant changes in the level of charges in the three months between indicative and final charges, is it reasonable to require a Board to issue, as part of their board assurance, a statement explaining why this has occurred and why this was not anticipated?

Q6 Do you agree with wholesalers being required to inform retailers of the separate prices for the different wholesale wastewater services they are being provided with? And, do you agree that it is appropriate that wholesalers should be required to consider how they will separate out – having considered the costs of these services and having appropriately engaged with their stakeholders – the different wastewater services they provide to their customers in England and Wales by April 2020?

Q7 Do you agree that a minimum list of non-primary charges should form part of all wholesale charge schemes? Do you agree that wholesalers, and not Ofwat, should look to ensure greater consistency in the terminology used to describe non-primary charges?

Q8 Do you agree with our proposals that wholesalers will be required to publish the methodology underpinning non-primary charges for a limited set of charges where these charges cannot be set in advance? Is this approach proportionate and will it be effective?

Q9 Do you agree that our approach to concessionary drainage charges will ensure appropriate transparency in these charges?

Q10 Do you agree that our proposal requiring wholesalers to publish the wholesale charge for any customer on a special agreement are proportionate and will be effective?

Q11 Do you have a view on the most appropriate approach to dealing with back billing – for example, would a general obligation in either the licence or the Wholesale-Retail Code, or a rule in the wholesale charging rules be more appropriate?

Q12 Do you agree that our proposed rule requiring NAVs in England and Cholderton and District Water Company Limited to publish wholesale charges will achieve our aims in a proportionate way?

## 4. Assurance and information requirements

### 4.1 Board assurance

Consistent with the charging rules we issued in 2015, we are proposing that company Boards provide us assurance that their wholesale charges comply with their legal obligations. We are also proposing to extend this requirement to indicative charges (see chapter 3).

As part of this assurance, we are proposing that companies (in England and Wales) produce a proportionate impact assessment where the wholesale charges faced by retailers (as a whole or in groups) are expected to increase by more than 5% from the previous year. And, as wholesale charges typically represent around 90% of the costs ultimately faced by a business, we will also require wholesalers to engage directly with business customers. This will ensure that wholesalers have appropriately engaged stakeholders in developing their wholesale charges and that they have revised their wholesale charges as appropriate.<sup>52</sup>

Board assurance is a powerful tool for ensuring that Boards are engaged with their wholesale charges, thus generating real company ownership of their responsibility to ensure that their wholesale charges are fair and reasonable. This in turn reduces the risk of unacceptable charges.

Our proposals recognise that there is already a requirement for companies to provide us with assurance statements each year with respect to retail charges. If a company providing both wholesale and retail services wishes to amalgamate the various Board assurances that they are required to provide to us – for example, on retail charges and on wholesale charges – we have no objections to this. But, companies that do this will need to assure themselves that their amalgamated Board assurance statement meets the necessary requirements.

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<sup>52</sup> In proposing this we recognise that retailers are subject to a similar rule and are required to engage with customers (both business and residential) when they are proposing significant changes to their retail charges.

## 4.2 Significant changes

Our regulatory model sees us moving away from ex ante regulation (where we prescribe in detail what companies need to do upfront, give upfront approval to plans and actions, and check compliance as a matter of course) to an approach more based on ex post action (where we set principles upfront, receive assurance of compliance, monitor risk and step in where needed). However, we consider there is still likely to be a benefit in wholesalers submitting to us a statement of any significant changes that they anticipate in their wholesale charges from one year to the next. This is to be provided to us so that we are informed of developments in markets at the wholesale and retail levels enabling us to take a view on how well the market is working and whether we need to step in. Wholesalers should not expect any endorsement from us on their proposal on receipt of such statements.

We are currently minded to set a requirement for wholesalers to issue a statement of significant change three months before they publish their final charges – at the same time that wholesalers will be required to publish indicative wholesale charges.<sup>53</sup> We appreciate that this proposal is more than three weeks before the date for publishing the final wholesale charges schemes but we have concerns with this information being published too late, thereby not providing sufficient time for retailers to develop their pricing proposals and effectively engage customers.

The statement will also confirm whether a wholesaler is expecting any changes to its wholesale charges scheme to result in significant bill increases for retailers (as a whole or in groups) and customers, whether in the contestable part of the retail market or not. In addition, it will provide details of any significant changes in charging policy from the previous year.

## 4.3 Consultation questions

Q13 Do you agree with our approach to Board assurance? And, do you agree with our preference for wholesalers to submit (where appropriate) a statement of significant change for primary wholesale charge at least three months before final wholesale charges are published?

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<sup>53</sup> This requirement builds on the requirement that we outlined in chapter 3 that wholesalers notify stakeholders (retailers and business customers) six months before they issue their final wholesale charges if they are considering significant changes to their charges (even where earlier engagement may have highlighted that this was the case).

## 5. Next steps

We welcome your responses to this consultation by **9 September 2016**.

We will issue our final wholesale charging rules in time for the opening of the business retail market in England (April 2017).

## A1 Draft wholesale charging rules

### WATER SERVICES REGULATION AUTHORITY WATER INDUSTRY ACT 1991, SECTIONS 66E AND 117I

#### Draft Wholesale Charging Rules

##### Introduction

1. These rules are issued by the Water Services Regulation Authority under sections 66E and 117I of the Water Industry Act 1991.
2. The rules apply to the charges that may be imposed by:
  - (a) a water undertaker under a section 66D agreement where a water supply licensee with a retail authorisation or a restricted retail authorisation is a party to that agreement; and
  - (b) a sewerage undertaker under a section 117E agreement where a sewerage licensee with a retail authorisation is a party to that agreement.
3. The rules have effect in relation to charges payable in relation to any period beginning on or after 1 April 2017.
4. The rules are supplementary to statutory provisions that apply to relevant undertakers under any enactment, or instrument made thereunder (including the conditions of their appointments), and in the event of any conflict between the rules and any statutory provision, the latter shall prevail.

##### Interpretation

5. Unless the context otherwise requires, in these rules:
  - **“Charging Year”** means a year commencing on 1 April;
  - **“Eligible Premises”** means premises that could be:
    - (a) supplied with water by a water supply licensee with a retail or restricted retail authorisation; or
    - (b) provided with sewerage services by a sewerage licensee with a retail authorisation.

“**Mogden formula**” means the following formula:

$$\text{Charge per unit of effluent} = R + [(V + Bv) \text{ or } M] + B(Ot/Os) + S(St/Ss)^7$$

where:

**R** = reception and conveyance charge [p/m<sup>3</sup>]

**V** = primary treatment (volumetric) charge [p/m<sup>3</sup>]

**Bv** = additional volume charge if there is biological treatment [p/m<sup>3</sup>]

**M** = treatment and disposal charge where effluent goes to sea outfall [p/m<sup>3</sup>]

**B** = biological oxidation of settled sewage charge [p/kg]

**Ot** = Chemical oxygen demand (COD) of effluent after one hour quiescent settlement at ph 7

**Os** = Chemical oxygen demand (COD) of crude sewage one hour quiescent settlement

**S** = treatment and disposal of primary sewage sludge charge [p/kg]

**St** = total suspended solids of effluent at ph 7 [mg/litre]

**Ss** = total suspended solids of crude sewage [mg/litre];

- “**rateable value charge**” means a charge fixed wholly or partly by reference to a rating valuation list or otherwise determined, whether directly or indirectly, by reference to any value or other amount specified at any time in such a list or which purports to be so fixed or determined;
- “**rating valuation list**” means a list which is or has at any time been maintained, for the purposes of rating, under section 41 of the Local Government Finance Act 1988, section 67 of the General Rate Act 1967 or any other enactment;
- “**service**” includes, but is not limited to, the supply of water;
- “**small companies**” means the following companies:
  - (a) any company holding an appointment as a relevant undertaker where the conditions of that appointment limit changes that can be fixed under a charges scheme under section 143 of the Water Industry Act 1991 by reference to the charges fixed by one or more other relevant undertakers; and
  - (b) Cholderton and District Water Company Limited.

- “**special agreement**” means an agreement to which section 142(2)(b) of the Water Industry Act 1991 applies;
  - “**unmetered wholesale charges**” means a charge for services that is not based on measured quantities of volume to any extent; and
  - “**wholesale charges**” means the charges that may be imposed by:
    - (a) a water undertaker under a section 66D agreement where a water supply licensee with a retail authorisation or a restricted retail authorisation is a party to that agreement; and
    - (b) a sewerage undertaker under a section 117E agreement where a sewerage licensee with a retail authorisation is a party to that agreement.
6. Unless the contrary intention appears, words and expressions used in these rules have the same meaning as in any provision of the Water Industry Act 1991.

#### Publication

7. Each water undertaker must publish the wholesale charges payable by a water supply licensee for the supply of water to Eligible Premises that are connected to the undertaker’s supply system. This includes the Eligible Premises to which a special agreement would otherwise apply.
8. Each sewerage undertaker must publish the wholesale charges payable by a sewerage licensee in respect of the provision of sewerage services to Eligible Premises that are connected to the undertaker’s sewerage system. This includes the Eligible Premises to which a special agreement would otherwise apply.
9. Each relevant undertaker must also, as a minimum, publish the wholesale charges (or the methodology for calculating such charges where the charges cannot be determined in advance) that would, where relevant, be payable by a water supply or sewerage licensee for:
  - a. the replacement of lead service pipes;
  - b. the provision and maintenance of fire hydrants;
  - c. damage to apparatus;

- d. the carrying out of inspections to ascertain whether any provision contained in or made or having effect under the Water Industry Act 1991 with respect to any water fittings or with respect to the waste or misuse of water is being or has been contravened;
  - e. site inspections;
  - f. the provision and use of standpipes;
  - g. the testing of meters; and
  - h. the disconnection of a service pipe (or for otherwise cutting off a supply of water) to any premises and the reconnection of such premises to a water main.
10. Wholesale charges must be published at least eleven weeks before the start of the period for which the charges will be imposed.
11. Wholesale charges must be published on a relevant undertaker's website and in such other manner as the undertaker considers appropriate for the purpose of bringing it to the attention of persons likely to be affected by it.
12. Wholesale charges must be published with such additional information or explanation as is necessary to make clear what services are covered by each charge.

#### General charging principles

13. Relevant undertakers whose areas are wholly or mainly in England must determine what types of charges may or may not be imposed and the amount of any charges that may be imposed in accordance with the principle that wholesale charges should reflect:
- (a) fairness and affordability;
  - (b) environmental protection;
  - (c) stability and predictability; and
  - (d) transparency and customer-focused service.

#### Principles for determining the amount of charges

14. Consistent principles and methodologies must be applied to the calculation of charges for different classes of Eligible Premises, regardless of the services provided.
15. Charging structures must reflect the long-run costs associated with providing the relevant service.

16. Differences between charges for services provided to premises that are larger users of water and sewerage services and charges for services provided to premises that are smaller users of water and sewerage services must only be based on cost differences associated with differential use of network assets, differential peaking characteristics, different service levels and/or different service measurement accuracy.
17. Where cost differences associated with differential peaking characteristics are used as a basis for differences between charges for services provided to premises that are larger users of water and charges for services provided to premises that are smaller users of water, the charges fixed on that basis must be structured on an appropriate peak demand basis.
18. Charges for sewerage services must take into account the different pollutant loads associated with foul water, trade effluent, surface water draining from premises and surface water draining from highways.

#### Unmetered charges

19. No unmetered wholesale charges may be imposed unless the basis on which those charges are fixed or determined is clear and, in the case of rateable value charges, it is clear:
  - (a) which rating valuation list charges are fixed or determined by reference to; and
  - (b) if the undertaker uses a different value or other amount to that specified in such a list, the methodology or other basis on which that different value or other amount is calculated.

#### Wastewater charges

20. Sewerage undertakers whose area is wholly or mainly in England must, in relation to each Charging Year beginning on or after 1 April 2020, separate wholesale charges for sewerage services into separate charges for the reception, treatment and disposal of:
  - (a) foul water;
  - (b) trade effluent;
  - (c) surface water draining from premises; and
  - (d) surface water draining from highways.

21. Sewerage undertakers must provide for an appropriate reduction in the wholesale charges payable for the provision of sewerage services to any premises where the sewerage undertaker knows, or should reasonably have known, that surface water does not drain to a public sewer from those premises.

#### Trade effluent

22. Charges to be paid in connection with the carrying out of a sewerage undertaker's trade effluent functions must be based on the Mogden formula, a reasonable variant of the Mogden formula or on a demonstrably more cost-reflective basis.

#### Concessionary drainage charges

23. The wholesale charges published by each sewerage undertaker must set out:
- (a) the classes of community group in relation to which the undertaker allows reductions in the wholesale charges payable by a sewerage licensee in respect of surface water drainage from Eligible Premises; and
  - (b) the reductions allowed.
24. Where a sewerage undertaker's charges scheme under section 143 of the Water Industry Act 1991 will include provision designed to reduce charges to community groups in respect of surface water drainage from their property, the amount of wholesale charges payable by a sewerage licensee in respect of the provision of sewerage services to Eligible Premises occupied by community groups must be determined in accordance with the principles that:
- (a) wholesale charges must be reduced in relation to the same classes of community group; and
  - (b) the reductions in wholesale charges must be the same and apply for the same period.

#### Special agreements

25. Where a special agreement would apply to the provision of services to Eligible Premises if the undertaker continued to provide the services, a relevant undertaker must impose on a water supply licensee or, as the case may be, a sewerage licensee only such charges as would enable the licensee to charge

for those services at the same rate or rates as would have applied if the special agreement had applied.

### Small companies

26. Paragraph 0 of these rules does not apply to small companies. Instead small companies that are wholly or mainly in England must publish their wholesale charges (or the methodology for calculating such charges) published at least nine weeks before the start of the period for which the charges will be imposed.

## **Annex: Information requirements**

### Assurance statements

- A1 Each undertaker should provide to the Water Services Regulation Authority an assurance statement from its Board of Directors and publish its statement no later than the time of publication of its wholesale charges confirming that:
- (a) the company complies with its legal obligations relating to the wholesale charges it has published;
  - (b) the Board has assessed the effects of the new charges on licensees (as a whole or in groups) who are retailing wholesale services to eligible customers and to business end-users (as a whole or in groups) and approves the impact assessments and handling strategies developed in instances where bill increases for licensees (as a whole or in groups) who are retailing wholesale services to eligible customers and business end-users (as a whole or in groups) exceed 5%;
  - (c) the company has appropriate systems and processes in place (including up-to-date models and data) to make sure that the information published about its wholesale charges is accurate; and
  - (d) The company has consulted with relevant stakeholders in a timely and effective manner on its wholesale charging schemes.

### Indicative charging information

- A2 No later than six months before publishing its wholesale charges, each undertaker (other than a small company), should if considering making any significant changes to its primary wholesale charges publish information that informs stakeholders of these changes, where significant will be if a reasonable person would consider them to be material.

- A3 No later than three months before publishing its wholesale charges, each undertaker (other than a small company) should provide to the Water Services Regulation Authority and publish indicative wholesale charges. For these purposes, “indicative wholesale charges” are the primary wholesale charges that the company reasonably expects to fix for the following period (based on the information available to it at that time).
- A4 No later than three months before publishing its wholesale charges, each undertaker (other than a small company) should, if it intends to make any significant changes to its primary wholesale charges, provide to the Water Services Regulation Authority and publish a statement of significant changes. For these purposes:
- (a) changes to the level of primary wholesale charges, or to the methodology for calculating them, will be significant if a reasonable person would consider them to be material; and
  - (b) a statement of significant changes should include:
    - (i) what changes are expected;
    - (ii) how licensees (as a whole or in groups) and business end users (as a whole or in groups) are likely to be affected; and
    - (iii) the handling strategies that may be adopted by the company or why the company considers that no handling strategies are required.
- A5 Each undertaker should provide to the Water Services Regulation Authority an assurance statement from its Board of Directors and publish its statement no later than the time of publication of its indicative wholesale charges confirming, using the best available information available at that time, that:
- (a) the company complies with its legal obligations relating to the indicative wholesale charges it has published;
  - (b) the Board has assessed the effects of the new charges on licensees (as a whole or in groups) who are retailing wholesale services to eligible customers and to business end-users (as a whole or in groups) and approves the impact assessments and handling strategies developed in instances where bill increases for licensees (as a whole or in groups) who are retailing wholesale services to eligible customers and eligible business end-users (as a whole or in groups) exceed 5%;
  - (c) the company has appropriate systems and processes in place (including up-to-date models and data) to make sure that the information published about its indicative wholesale charges is accurate; and
  - (d) The company has consulted with relevant stakeholders in a timely and effective manner on its wholesale charging schemes.

## A2 Charging rules and the regulatory framework

This appendix provides information on aspects of the charging regulatory framework. Specifically, it considers the interaction of:

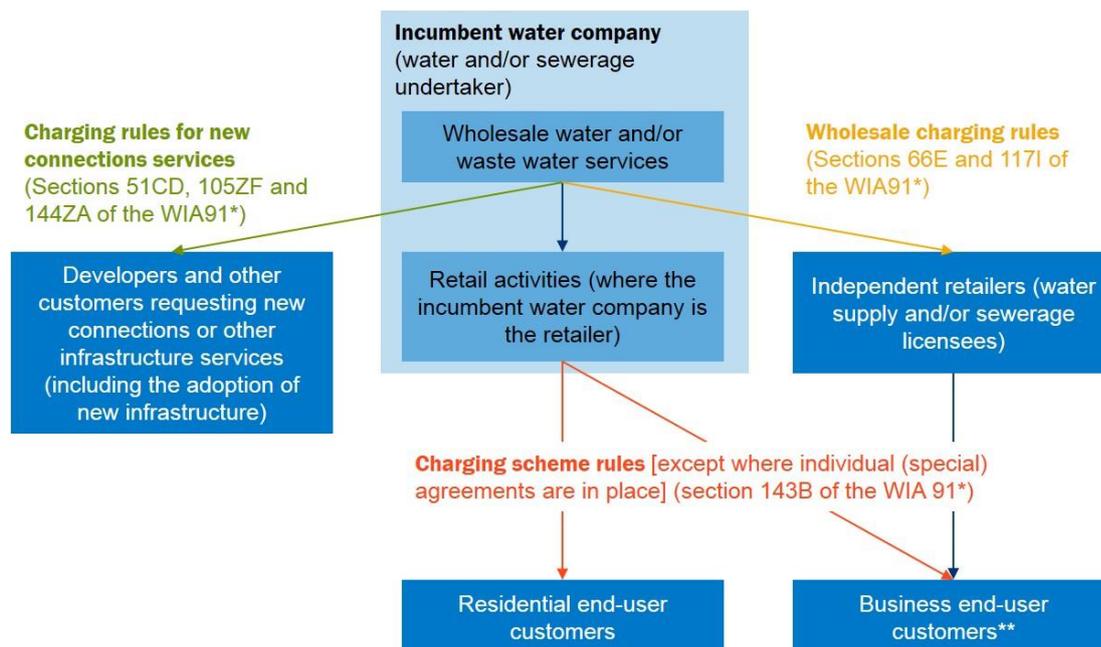
- our charges scheme rules and our wholesale charging rules;
- [IN 16/02](#) and our wholesale charging rules; and
- information requirements regarding wholesale charges.

The high level information we have outlined below is provided to help provide clarity. Stakeholders are encouraged to engage their own experts to determine how they should best meet their requirements and obligations.

### Interaction of our retail charging rules and the wholesale charging rules

The figure below illustrates, in a simplified form, how the retail charging rules and the wholesale charging rules interact.

**Figure 1: Interaction of our charging rules**



\*WIA 91 = Water Industry Act 1991

\*\* By 'business end-user' customers we mean non-residential premises. Not all such premises will be eligible to be supplied by water supply and sewerage licensees.

## A2.1 Relationship between IN 16/02 our proposed wholesale charging rules

Recognising that our wholesale charging rules would not be set early enough in 2016 to ensure that indicative wholesale charging information would be available to retailers in 2017/18 we issued IN 16/02 to request this information from large companies for 2017/18 by October 2016. We also indicated that we expected large water companies to notify stakeholders in July 2016 if they anticipate significant changes to their wholesale charging structures in 2017/18 and what those changes may be.

IN 16/02 also highlighted that we also expect large water companies to provide us assurance that their indicative charges are the charges that they expect to set for 2017/18 (based on the information available to them at that time) and that they comply with all the relevant legal requirements. We also noted that we expect large water companies to notify stakeholders in July 2016 if they anticipate significant changes to their wholesale access charging structures in 2017/18 and what those changes may be.

IN 16/02 therefore outlines the requirements that companies are required to comply with respect to indicative wholesale information in July and October of 2016 for indicative wholesale charges for 2017/18. Our wholesale charging rules outline the requirements for indicative wholesale information (among other issues) that wholesalers must comply with every year thereafter.

## A2.2 Information requirements regarding wholesale charges

There will be at least three separate sources of requirements for wholesalers to publish wholesale charging information, and these requirements are summarised in the table below.

	Condition B (charges)	Draft wholesale charging rules	Draft wholesale-retail code
Content	Wholesalers are “required to publish charges fixed for the purposes of demonstrating compliance with the Price Controls determined in respect of [their] Wholesale Activities” (para. 9 (WoCs) or 10	“the charges that may be imposed by a [water undertaker or a sewerage undertaker] under a [section 66D or 117E] agreement” with a water supply licensee or a sewerage licensee (new sections 66E and 117I of the Water Industry Act 1991).	Wholesale Tariff Document: “the Document published by the Contracting Wholesaler from time to time setting out its current Wholesale Charges together with all Primary Charges calculated in relation to a Special Agreement by reference to the relevant Factor(s) and Tariff(s) as set out in the Special Agreements Register” (definition in Part 1 of the Wholesale-Retail Code (“WRC”).

	<b>Condition B (charges)</b>	<b>Draft wholesale charging rules</b>	<b>Draft wholesale-retail code</b>
	(WaSCs) of Condition B).		The draft WRC also includes requirements for undertakers to “Register Wholesaler Tariff Data in accordance with the Settlement Timetable to allow the Market Operator to calculate Primary Charges” (section 4.2.3 of Part 4 (Market Terms) of the WRC).
Coverage	This will cover wholesale charges in relation to both residential and business customers.	This will cover wholesale charges for business customers.	This will cover wholesale charges for business customers.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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