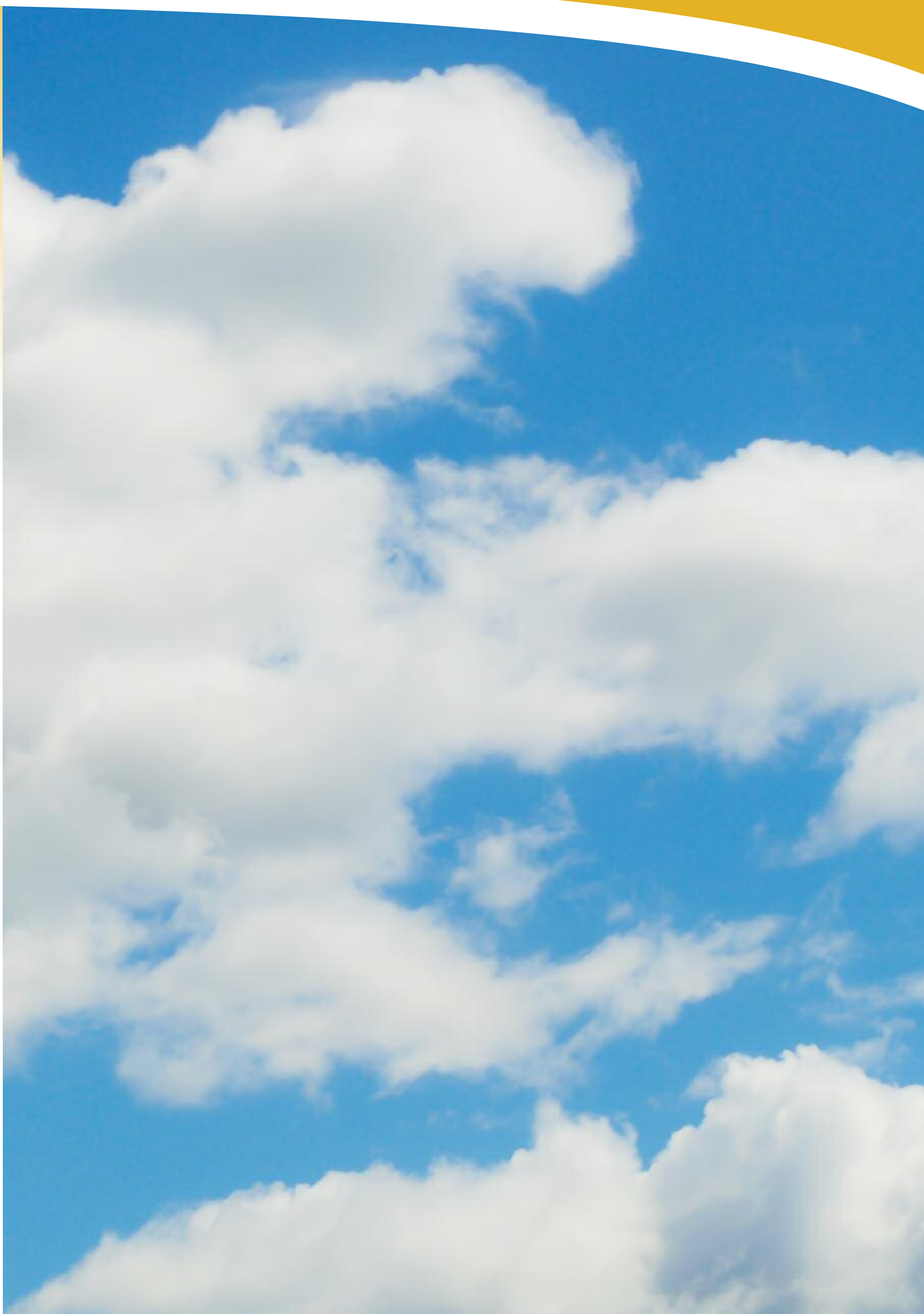
Water today, water tomorrow

Consultation on retail controls for the 2014 price review



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About this document

In ‘Future price limits – statement of principles’ (‘the statement’), which we published in May 2012, we set out the high-level principles that we will apply at future price reviews. We also committed that for the 2014 price review, we will set separate wholesale and retail price caps or ‘controls’. This will include two separate retail controls – one for customers that are, or are likely to become, eligible to choose their supplier (‘contestable’) and one for customers that are likely to remain ineligible to choose their supplier (‘non-contestable’).

In the consultation leading up to our statement, stakeholders raised a number of questions about how our proposals would be implemented for the next price review. So alongside our statement, we published ‘From principles to price setting – next steps’, where we set out our plan of work to engage with stakeholders on these issues and determine the scale and pace of change for the next price review. This included a commitment to consult formally on the issues associated with the retail and wholesale controls separately.

This consultation sets out some of the key issues associated with setting retail controls for the next price review and invites views on how we might address them.

To implement separate retail controls, we recognise that we need to modify water company licences. We published a consultation in December 2011 that proposed some modifications that would enable us to set separate price controls. In response to the issues raised through that consultation, we are carrying out a further engagement exercise with all stakeholders, including companies and investors to identify the best way of addressing these.

Our statement of principles was accompanied by a detailed impact assessment (IA). This IA presented the potential impacts of the policy changes proposed by Ofwat following a period of consultation with stakeholders on that evidence base. In most areas covered by this consultation the evidence base has not changed significantly since May. So, we have not sought to re-cast that detailed analysis and include a similar impact assessment alongside this consultation. This would duplicate the work that we have already provided. Instead, we intend to present a full impact assessment analysis on our methodology proposals for the next price control in the autumn, when we publish our formal methodology consultation.

Contents

Key messages

- This consultation explores some of the key issues associated with setting separate **retail price controls** for water and sewerage services, including those that respondents raised to our future price limits consultation in November. A separate consultation later in the summer will address issues associated with setting a wholesale control.

- Separate price controls will create stronger and more closely targeted incentives on the retail activities companies provide to customers and drive those companies to deliver better customer service at a lower cost. This supports our principles of setting more targeted price controls with more effective incentives.

- They will also support the UK Government's ambitions to allow greater choice for non-household customers by ensuring that the regulatory arrangements can accommodate these changes.

Definition of 'retail' services

- We present our view of the 'core' activities which, based on previous feedback, we consider should sit within the defined retail business. And we define a number of 'fringe' activities – including metering and network calls – where there is no clear consensus among stakeholders about where they should be allocated.

Allocation of costs

- We are conscious of the need to ensure that the costs associated with providing these services are correctly and robustly allocated. We will consider any additional action necessary to address cost allocation issues outside of this consultation after companies publish their most up to date retail costs in July.

Price controls for customers with no choice

- We propose setting price controls for customers that will not have a choice of supplier (mainly household customers) based on the average cost of providing water and sewerage services to customers across the sectors. This will protect customers that will continue to be served by monopoly companies. At the same time, it will simplify our approach to regulating retail services and give those retail companies that perform well the opportunity to innovate and outperform in how they deliver to their customers.

- We set out our preferred approach to calculating the average cost to serve and the principles we would apply when considering adjustments to that average for issues outside companies' control.

- We recognise that moving away from a regional, company-specific price control to setting one based on an industry average cost to serve could create winners and losers among customers and investors if it is not managed carefully. This is an area of significant concern for Ofwat.

- We are carrying out additional work on these issues with United Utilities to better inform responses to our consultation. We are grateful for the company's participation in that work.

Price controls where customers have choice

- Finally, we set out how we will protect those customers that are, or are likely following the recent publication of the UK Government's Water White Paper and draft Water Bill, to become eligible to choose their supplier ('contestable' customers). We intend to use a 'default tariff' approach to ensure that consumers are protected while not impeding the benefits of that market. We are also carrying out a joint project with Thames Water on these issues to better inform responses to our consultation. Again, we welcome the company's participation and involvement.

Give us your views

- We welcome your feedback on the proposals set out in this consultation. We recognise that it does not cover all of the concerns raised by stakeholders and that many of the issues between retail and wholesale price controls are inter-related. We are open to feedback from stakeholders on these outstanding issues and interrelationships, even where we do not cover them in this consultation.

Consultation questions

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

How could we define retail?

Q1 Do you agree that the 'core' customer-facing services should all be included within the retail control? If not, please explain which core services should be included in retail and which should be excluded, and why.

Q2 Do you agree that trade effluent compliance monitoring and developer services should be allocated to the wholesale price control?

Where should we allocate the responsibility for providing the network calls service?

Q3 Please explain whether you think the responsibility for providing the network calls service should be allocated to the retailer or the wholesaler? Please explain the reasons for your preferred approach.

Where should we allocate the responsibility for providing, owning and maintaining meters and the meter co-ordination service?

Q4 Should the responsibility for meter ownership, installation, maintenance and replacement be allocated to the retailer or wholesaler? Please explain the reasons for your preferred approach.

Q5 Are there any other arrangements that we should consider? If so, what are they and why should we consider them?

What should be done about disconnections?

Q6 Should disconnection services be allocated to retail, or should it remain part of the wholesale price control? Please explain the reasons for your preferred approach.

Q7 Who should retain responsibility for disconnection and why?

Where should we allocate demand management services?

Q8 Should the responsibility for demand management services be allocated to the retailer or the wholesaler? Please explain the reasons for your preferred approach.

Who should be responsible for customer-side leaks?

Q9 Should services relating to customer-side leaks be allocated to retail or wholesale, or is there an alternative arrangement that we should consider? Please explain the reasons for your preferred approach.

Cost allocation issues
Q10 Do you agree with Ofwat's proposed approach to considering and addressing cost allocation issues? If not, what other approach should be taken and why?
Interaction between retail and wholesale controls
Q11 Do you support our approach to passing through wholesale costs? If not, what alternative approach would be more suitable and why is this superior to our proposed approach?
Arithmetic issues in calculating average cost to serve – the denominator
Q12 Please explain whether you agree that we should calculate the denominator based on the number of customers billed, with an adjustment to reflect the economies of scope associated with billing both water and sewerage services? If not, please explain what alternative options we should consider and why.
Arithmetic issues in calculating average cost to serve – weighted or unweighted averages
Q13 Please explain whether you agree with our preferred approach to calculate average retail costs based on an unweighted average? If not please explain what alternative options we should consider and why.
Applying an average cost to serve
Q14 Please explain whether you think we should apply the average cost to serve as an upper limit for each company's price caps or whether we should apply a cost to serve challenge based on the most efficient costs? **Q15** Are there other options we should consider? If so, what are they and why should we consider them?
Adjustments to the average cost to serve
Q16 Please explain whether you agree with our preferred approach to only make adjustments to the average cost to serve if (i) the impact is material; and (ii) the factor is outside a company's control? If not, please explain your preferred approach. **Q17** Please explain whether you agree that where we make adjustments, they should be on the basis of efficient costs. **Q18** Please explain whether you think such adjustments should one-sided or two-sided and why.
Impact on incentives
Q19 Please identify and discuss if there are any services that are retailer might have a lower incentive to deliver on account of an average cost to serve efficiency challenge. For each service, please explain how material the issue is using evidence to support your answer.

Q20 How should we address these issues?

How prescriptive should default tariffs be?

Q21 Do you think we should apply default tariffs using principles or through a highly prescriptive approach? Please explain your answer.

Q22 Are there alternative approaches we should consider? If so, what are they and why should we consider them?

Setting the default tariffs – a prescriptive approach

Q23 If we adopted a more prescriptive approach to applying the default tariff, how should the default tariff be set and structured? Please explain your answer.

Migrating onto default tariffs

Q24 Should we require companies to migrate customers onto default tariffs, or just offer these as a reference price? Please provide evidence in support of your answer.

Q25 Should the default tariff apply to all customers that have choice? Please explain your answer.

Q26 Are there alternatives to the default tariff that we should consider for larger customers? If so, what are they and how should they work?

Default service levels

Q27 Do you support our proposed approach to set a default service level based on the existing service standards. If not, why not?

Responding to this consultation

We welcome your responses to this consultation by **Friday 24 August 2012**. Given the short consultation period, we will be supplementing this with a formal workshop on 16 July, which will give stakeholders a further opportunity to respond to the issues raised in this document. We will also hold a number of face-to-face meetings with the companies and other stakeholders.

Following a direct approach from some of the companies, we are currently carrying out additional joint work with Thames Water and United Utilities. We expect the results of this work to be made available publicly during the course of this consultation. So, we invite stakeholders to comment on the outcomes of that work.

You can email your responses to shane.anderson@ofwat.gsi.gov.uk, or post them to:

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If you wish to discuss any aspect of this document, please contact Shane Anderson on 0121 644 7618 or by email at shane.anderson@ofwat.gsi.gov.uk. We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

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

1. Introduction and objectives of retail price controls

In 'Future price limits – statement of principles', we said we would introduce separate retail and wholesale controls at the 2014 price review. This reflects our future price limits principles to:

- **target our price control regulation appropriately** by using regulatory tools that better reflect the underlying economic characteristics of the business and focusing incentives carefully to deliver desired outcomes;
- **set price controls in a way that gives companies ownership and accountability for delivery of what customers want and need**;
- **use a risk-based approach** to the way in which we regulate to ensure that regulatory scrutiny and burdens are targeted appropriately and are proportionate to the risk we have identified; and
- **design and use our regulatory tools in a way that is future proof and capable of adapting to support the water and sewerage sectors** – the framework must allow sufficient flexibility to respond to challenges as their effects become known.

1.1 The structure of price limits in 2014

We committed to introduce separate retail price controls, which would include:

- a cap on the amount of revenue that could be recovered through the prices charged to those customers that are not eligible to choose their supplier: ('non-contestable' customers). This cap would reflect the average cost of providing a customer with these retail services, which would act as a challenge to companies with above-average costs to be more efficient; and
- a default tariff or tariffs for customers that are able to choose their supplier: ('contestable' customers).

And we committed to having a wholesale control, which will be the subject of a separate consultation later in the summer.

In table 1 below, we set out an overview of the wholesale and retail price controls.

Table 1 Overview of the wholesale and retail price controls

Wholesale	
Wholesale price control	· Includes all wholesale services (including abstracting, treating and transporting water, and collecting, treating and disposing of wastewater). · Applies to all customers. · Wholesale charges regulated using a methodology that is consistent with the historic return on capital approach with indexation. · Allocating the value of all capital assets to the wholesale control (RCV) and continuing to index these changes by the Retail Price Index (RPI) maintains investor confidence.
Retail	
Retail price control for customers with choice	· Encapsulates customer-facing 'retail' services. · Applies to non-household customers with different arrangements in England and Wales dependent upon Government legislation. · Prices controlled using 'default tariffs' until the market is operating effectively, to safeguard those customers that do not choose to switch their supplier from unreasonable price rises or drops in service. · Companies can innovate and provide differentiated levels of service and associated price in response to customer demand, thus delivering choice.
Retail price control for customers without choice	· Encapsulates customer-facing 'retail' services. · Applies to all household customers and some non-household customers dependent upon Government legislation. · Prices are set based on an average cost of providing a customer with these retail services, which acts as a challenge to those companies with costs above the average to be more efficient. · A simple form of regulation and efficiency challenge.

1.2 The objectives for separate retail price limits

We made the choice to set price limits in this way in the future by identifying the challenges that the sectors are facing and how a different approach to setting price limits might help the sectors respond to those challenges.

This led us to certain objectives for future price limits. And based on that work, we defined our objectives for separate retail price controls as follows.

- **To incentivise more efficient use of water** by setting price controls in a way that maximises the opportunities for demand management.
- **To encourage better customer-facing outcomes** by making sure that:
  - those customers that can choose their supplier enjoy an effective market place for these services, maximising the benefits of that market for economic, social and environmental goals; and
  - customers that cannot choose their supplier receive a good service at a fair price, which is protected through regulation.
- **To continue to enable efficient investment** in the sectors by setting price controls in ways that continue to give stability and predictability to investors.
- **To help to mitigate and adapt to climate change**.
- **To use a risk-based approach to set price controls** that are simple and reduce the burden of the price control process while also giving companies scope to innovate.

1.3 The structure of this consultation

Stakeholders raised a number of concerns with our approach to setting separate retail and wholesale price controls in 2014. We summarised these in the summary of responses that accompanied our statement of principles. This consultation sets out some of the key issues associated with setting retail controls for the next price review. It also describes some approaches to address those issues, and invites views and input from our stakeholders.

The consultation has five chapters and is structured as follows.

- **Moving from a vertically integrated control to separate wholesale and retail controls**. In the first four chapters, we discuss the steps that are required to make the transition from a single vertically integrated control to separate controls for wholesale services and for the contestable and non-contestable retail services. This includes defining the core retail services that would be regulated under the retail control (chapter 3) and those fringe services that could be regulated under either the retail or wholesale controls (chapter 4). We also discuss some of the issues associated with ensuring that costs are appropriately allocated between the retail and wholesale controls (chapter 5). Finally, we assess some of the issues associated with splitting the control once the relevant services have been defined and discuss the interaction between the retail and wholesale controls.

- **Designing the retail controls.** In the final two chapters we discuss how we might design the retail controls for customers that have choice and those that do not. For those customers with no choice, we have set out a range of options for how the price limit based on the average cost of providing retail services should be calculated – including whether any adjustments should be made and how we might address potential disincentives for services such as metering, water efficiency advice and social tariffs (chapter 6). For those customers with choice we explore a range of options for setting default tariffs – including how we move from existing tariffs and the standards of service that could apply to those tariffs (chapter 7).

These are all issues that stakeholders raised with us in their responses to our consultation on the future price limits framework. In each instance, we have generally sought to set out a range of options for addressing the concern that stakeholders have raised, consider how effectively each option would meet our stated objectives and invite views on what the best approach would be.

2. Defining 'core' 'retail' services

To regulate companies' customer-facing 'retail' services separately from the more network-oriented 'wholesale' services we need to resolve what these respective services comprise and what activities are carried out to provide them. The scope of the retail price controls is the definition of the services that they would cover. Any services that are not allocated to the 'retail' price controls will fall under the 'wholesale' price control.

We considered the definition of retail services:

- in our future price limits consultation in November;
- as part of our accounting separation project in 2009; and
- in a discussion paper that we published in May of this year.

As a result of that work, we know that stakeholders have a range of views on the scope of retail services. So, in this chapter we set out the key issues associated with allocating these services and their related activities to either the retail or the wholesale price controls.

2.1 Obligations, services and activities

The existing regional providers of water and sewerage services in England and Wales are licensed companies. The condition of the licences, and the legislation that underpins them, places certain obligations on the companies. For example, they are required to provide certain levels of service to customers in their region and ensure specified environmental standards are met. The companies are responsible for meeting these obligations to their customers and face penalties if they do not do this.

That said, our economic regulation does not prescribe how the companies should meet these obligations, and they are free to choose whatever structures and methods they wish to do this. In meeting those obligations that relate to customer-facing 'retail' activities, the companies have chosen to carry out certain activities, such as billing, metering and customer contacts. The information that companies publish every year as part of their accounting separation work reflects these activities and the costs of carrying them out, not the services that they are required to provide as part of their obligations.

But where a retail business – including those entrants that will be competing with incumbent companies for the custom of non-households – wishes to buy wholesale water and wastewater for their customers they will wish to buy a service rather than an activity. In some instances, there will be a subtle difference between the service that they are buying and the activity. But the difference is an important one because, like any other customer, the entrant will be looking for a good service at a fair price and will most likely be challenging the wholesale business to seek new and different ways of delivering that service more efficiently or effectively.

As part of the next phase of our accounting separation work, we have defined a list of services for companies to report against in the future. We are proposing to collect this service-based information on a trial basis in 2012-13 and will consult on this separately.

The distinction between obligations, services and activities is important when considering the definition of retail services. This is not just because retailers will be buying services rather than activities, but also because there may be sensible solutions that maximise the benefits of reform and minimise the costs by allocating the responsibility to the wholesaler or the retailer, but still allow the retailer to play a role in delivering that service or activity.

- An **'obligation'** is a requirement that is placed on companies, usually through legislation or the conditions of company licences, that requires the companies' to deliver certain outputs or outcomes.
- A **'service'** is an output or outcome that a company provides, which a customer or supplier may purchase from the company. This might involve a range of activities on which the company incurs costs.
- An **'activity'** is a function or range of functions that a company chooses to carry out in order to meet its obligations. Companies will incur costs associated with carrying out these activities.

For example, if an obligation were placed on the retailer to provide a meter to a customer then the retailer could contract with the wholesale business to do this. In a model where all non-household customers had choice but households did not, retailers serving household customers would still be part of the same integrated business and metering assets could still be owned and managed by the wholesale business. For contestable non-household customers, entrant retailers could still choose to contract with the wholesale business to provide metering services or indeed contract with another party, such as a list of approved wholesale suppliers or alternative providers.

2.2 A consistent definition across both retail price controls?

We propose to set two separate retail controls:

- one for contestable customers that can choose their supplier; and
- one for non-contestable customers that cannot choose their supplier.

We need to consider whether there is a case for defining the scope of retail differently for the contestable and non-contestable retail controls.

This is not simply an issue of cost allocation; it is important to consider what services and risks the retailer and the wholesaler will be responsible for managing – particularly in a contestable retail market where there are likely to be numerous retailers.

If the same services and responsibilities are allocated differently between the contestable and non-contestable retail price controls, it would have implications for the setting of wholesale charges and the complexity of doing so. Charges should reflect costs (and therefore activities). So, if there is not a single, clear boundary between wholesale and retail activities for both contestable and non-contestable retail markets, two separate wholesale charging arrangements would be required.

For example, if we included network calls in the contestable retail price limit but not the non-contestable one, then the split of the activity required for the service concerned would need to be reflected in different wholesale charges. In this example, wholesale price limits for contestable customers would need to exclude the costs associated with network calls. But the wholesale price limits for non-contestable customers would need to include these costs. This would imply two wholesale controls and two associated retail controls, and would represent a marked increase in complexity and regulatory burden. This would conflict with our principle to set proportionate price controls and, to a lesser extent, to set price controls in a way that is transparent and predictable.

One issue of particular concern is that the UK Government has suggested that it will alter the boundary between contestable and non-contestable retail markets within the life of our proposed controls. So, this might require adjustments to the cost allocations and controls affected by the proposed changes in the boundary between contestable and non-contestable retail markets. This type of additional complexity implies that there are advantages to setting a consistent definition of retail and wholesale activities from the start. This links with our principle for setting price controls in a way that is future proof and can accommodate these changes.

In his independent review of competition and innovation in water markets, Professor Martin Cave also considered the potential ‘spill-over’ benefits to those customers that are not able to choose their supplier if some other customers served by the same incumbent retailer are given choice. As the review described, introducing choice for some customers can drive efficiencies in the retail business overall. Also, improvements in customer services for those that can choose to switch supplier can then be passed on to those that cannot switch, assuming that they are served by the same retail operation. Any positive spill-over benefits are more likely to occur if there is a consistent definition of retail services across both controls.

We consider that setting different definitions of retail services across both contestable and non-contestable price controls is likely to lead to a significant increase in complexity and could limit the achievement of some ‘spill-over’ benefits. But the arguments for allocating certain services to either the retail or the wholesale price control are likely to be very different in a situation where customers have choice compared with one where they do not.

2.3 A joint market across England and Scotland

In its Water White Paper, the UK Government committed to “establish a new market for retail water and sewerage services in partnership with the Scottish Government”. A ‘joint market’ between England and Scotland could represent a range of possible outcomes. The further the degree of harmonisation that could be achieved, the more consistent the market arrangements would be. This would likely lead to benefits for both market participants and those end customers that had the ability to choose their supplier.

2.4 Why does the service definition matter?

The definition of retail will have implications for customers, companies and their investors.

The choices that we make will also influence the extent to which our separate controls collectively meet the objectives that we have identified in our statement of principles. This includes the specific objectives for retail controls set out previously and also any specific objectives that we have for wholesale controls.

2.4.1 Implications for customers

One of the main reasons for setting separate retail controls is to bring about better customer-facing outcomes. The scope of services within the retail control will have a significant impact on the extent to which this objective is achieved.

The more services and activities that are under the control of the retailer, the more activities we can incentivise them to focus on in response to customer preferences.

In the future, the UK Government has committed to extending the existing framework of choice to allow all non-household customers to choose their supplier. For those customers that can choose their supplier, defining the contestable retail control more widely, and including more 'fringe' services, will increase the value of services over which they can choose alternative arrangements. It would result in a broader market place, with larger opportunities and margins for suppliers. The probable result of this would be to increase the level of rivalry and choice that customers have over these services. Including more of the 'fringe' activities would also support greater innovation and benefits to customers.

In some instances, a broader definition that encompasses all customer-facing activities would also allow for a single point of contact for the customer. This would reduce the number of parties they would need to contact if they experienced a problem.

Finally, in other utility sectors where similar arrangements have been introduced, the retail businesses have placed an important and beneficial challenge on the wholesale business. Acting as a strong advocate for end customers, and with more significant buying power, retailers have been able to negotiate better wholesale services for end customers. A broader definition of the scope of retail increases the extent to which the retailer can provide this 'upstream pressure'.

But widening the scope of the contestable retail control also increases the complexity of the market in some areas. For some services, such as metering, it could also have the potential to create barriers to customers switching. For example, customers could be persuaded to switch retailers in exchange for metering or other services that effectively tied them to the new retailer for a long period of time.

The perspective for customers that cannot choose their supplier is quite different. This has important implications for the way that the non-contestable retail control is structured and how efficiency is incentivised. On one level, allocating a broader range of activities and services to the non-contestable retail control and using an efficiency challenge based on the average cost of providing these activities to customers, will increase the activities that are subject to a more focused efficiency challenge. This provides more effective incentives for those companies with above-average costs to become more efficient.

But taking such a broad definition could also reduce the incentive on companies with above-average costs to invest in their retail operation and, for example, introduce new meters or provide water efficiency advice. Unless there were balancing incentives to provide good quality services (from the market or regulatory requirements), this would clearly conflict with another one of our core objectives.

2.4.2 Implications for companies and their investors

We might expect the implications and concerns for companies and their investors will be similar for both the contestable and non-contestable retail controls because they are likely to be predominantly concerned about the (much larger) wholesale business. In setting separate retail controls, another of our objectives is to ensure that on-going efficient investment in the sectors is maintained. This is critical to ensuring the sectors are able to meet the challenges of the future.

The scope of the retail services will affect the way in which the costs of providing those services are recovered from customers. Where services are allocated to the wholesale control, companies will be able to continue to recover the costs of carrying out these services from customers, subject to a strong efficiency challenge by Ofwat. This is because there will be limited competition for the wider set of wholesale services concerned.

But where services are allocated to the retail control, they will become contestable for those customers that have choice. For those customers that do not have choice, the costs could still be recovered from customers, although they may be subject to a more focused efficiency challenge than if they remained in the wholesale control.

We recognise that companies may consider that a wider definition of retail puts more of their price controlled revenues at risk. But in practice, non-contestable retail revenues would still be recovered from customers, albeit subject to our more focused regulatory efficiency challenge. Correspondingly, the additional market risks (separate from the price control risks) can be diversified for contestable retail revenues, as each company would also be able to approach other contestable customers for their business.

We might expect companies and their investors to be particularly concerned about the implications of split controls for capital investments and assets. The historic model of economic regulation in water and sewerage has been a return on capital approach. This reflects the capital-intensive nature of the sectors.

Companies and their investors will be concerned about the risks of asset stranding arising from split controls. They may also see themselves as asset managers. We are committed to leaving all of the existing RCV within the wholesale control. The RCV is a key measure for investors of the value of the existing assets that the companies hold.

Similarly, including a broader range of services in the contestable retail control is also likely to increase the complexity of the retail market place and the associated arrangements for companies in some areas. Allocating more fringe services to the contestable price control will, following legislative changes by the UK Government, allow companies other than the incumbent service provider to carry out the associated activities. This will increase the amount of contact and information exchange that companies need to manage between different parties.

This complexity reflects a move away from a regional model of water and sewerage retailing to a national market place for these services. Correspondingly, the current model places a similar burden on customers with sites across the country. Clearly, the complexity of the model and the risk of greater information exchange will be greater for companies if the scope of retail services is widened.

The impacts and implications on companies and investors may be slightly different for the non-contestable retail control. Companies and some investors may prefer more services to be allocated to the wholesale control. But, as discussed previously, a wider definition of the non-contestable retail control may also affect companies' incentives. This is particularly important for incentives to invest in new metering assets.

2.5 How could we define retail?

The work we carried out as part of our accounting separation project and the experience of retailing in other sectors, including Scotland, has allowed us to identify a 'long list' of potential activities and services that could be allocated to the retail price controls. In our accounting separation work, we chose to allocate activities to the retail business unit where they:

- involved direct interaction with a customer; and
- were potentially contestable (that is, they did not represent a service that should only ever be provided by a single network business).

Applying these two principles has resulted in a relatively broad definition of retail activities and services. In the table below, we set out the full list of activities and services that are currently allocated to 'retail' for accounting purposes. These activities are applied consistently for both household and non-household retail accounts.

Table 2 Retail activities and responsibilities from our accounting separation work

Billing	Payment handling
Non-network calls	Debt management
Meter reading	Network calls
Meter ownership, installation and maintenance	Disconnections
Demand management	Customer-side leaks
Trade effluent compliance	Developer services

We will be consulting shortly on amendments to the regulatory accounting guidelines (RAGs) and any changes to the definition of retail for the purposes of companies' regulatory accounts.

2.5.1 'Core' and 'fringe' retail activities and services

Having considered all of the potential services/responsibilities and supporting activities that could be allocated to retail or wholesale and the feedback from stakeholders, it is clear that the activities currently allocated to the retail business unit for accounting separation purposes can be placed into two groups. These groups are:

- some ‘core’ activities, where there is broad agreement among stakeholders that a service should be part of customer-facing ‘retail’ services; and
- some ‘fringe’ activities, where there are differing views among stakeholders about whether or not they should be allocated to the retail control.

We set out these in the table below.

Table 3 ‘Core’ and ‘fringe’ retail activities and services

Core services	Fringe services
Billing	Network calls
Payment handling	Meter ownership, installation and maintenance
Non-network calls	Disconnections
Debt management	Demand management
Meter reading	Customer-side leaks

We have excluded trade effluent compliance or sampling and developer services from these two lists. We have assumed that both of these activities should be allocated to the wholesale price control for the reasons set out below.

Trade effluent sampling is simply a compliance activity – it is one for which the wholesale or network business is likely to be primarily concerned, since it will bear the risk of customers not meeting their trade effluent requirements. So, we have concluded that this activity should be allocated to the wholesale price control in the first instance. Billing enquiries in relation to trade effluent would still form part of the core retail services alongside other billing enquiries.

The framework for new appointments or variations already gives developers choice in how they procure these services, so the benefits for end customers of introducing greater choice could confuse rather than improve the current arrangements. We also note that the UK Government has committed in its Water White Paper to introduce a ‘network’ licence to allow choice in the provision of network-related services. Subject to further clarification, this may represent a more effective route of providing these services. We also think that developers are very different from other non-household customers. This is because they will often be looking to procure network services as well as retail services. So, we have concluded that developer services should be allocated to the wholesale price control in the first instance.

Apart from these two exceptions, we propose to allocate all the core retail services/responsibilities and their supporting activities to the retailer and to the retail control.

Consultation questions

Q1 Do you agree that the 'core' customer-facing services should all be included within the retail control? If not, please explain which core services should be included in retail and which should be excluded, and why.

Q2 Do you agree that trade effluent compliance monitoring and developer services should be allocated to the wholesale price control?

3. Allocating 'fringe' retail services

In the previous chapter, we set out the key issues that we will need to consider in defining the services and activities that become part of the retail price control and the allocation of the 'core' retail services (as set out in table 3). In this chapter, we consider the allocation of the 'fringe' retail services and activities, looking first at the allocation of these services in other utilities where separate price limits have been introduced and then considering each service individually.

3.1 Fringe services and activities – lessons from other utilities

In all comparable UK utilities, the customer-facing retail services are already regulated differently from network services. This is a reflection of their different economic characteristics. A very relevant precedent is the experience of the water and sewerage sectors in Scotland, although this excludes the additional complexity of retail services for household (non-contestable) customers, which local government still provides. But the experience of the UK's energy and telecommunications sectors also has relevance.

In all of these sectors, all non-household customers can already choose their retail supplier. And in the case of the UK's gas, electricity and telecommunications sectors that choice has also been extended to household customers.

These other utility sectors have introduced separate price controls for 'retail' or 'supply', and decided which services and activities should be part of that control. Also, many of these retail arrangements have been deregulated entirely, where it has been appropriate to do so. In all these examples there are important lessons to learn about the allocation of these 'fringe' services/responsibilities and activities in particular.

A critical learning point from the examples outlined above is that the definition of retail services has evolved and changed in every instance. In fact, the general trend in each case has been for the scope of retail services to become wider – mainly because of changes made by the regulator and requests from market participants.

Many of these 'fringe' services and activities are included within the definition of retail for the non-household water market in Scotland – but in many instances they did not start out in retail from the outset. For others, while the responsibility and the costs for the service sit within the wholesale charges of Scottish Water, there are a range of approved suppliers that are able to carry out these activities. This gives retailers some choice over where they procure these services other than from the incumbent. In the table below, we set out the allocation of these peripheral responsibilities and activities in the electricity, gas and telecommunications sectors.

Table 4 The scope of 'fringe' retail activities in other sectors

Activity	Scottish water sector	Electricity	Gas	Telecoms
Network calls	Yes (in particular initial contact)	No	No	Yes
Meter ownership	No	Yes (can be retailer or network)	Yes (can be retailer or network)	n/a
Meter maintenance, installation and replacement	Yes (can appoint accredited company to carry these out)	Yes (can be retailer or network)	Yes (can be retailer or network)	n/a
Temporary disconnections (for non-payment of charges)	Yes (can appoint accredited company to carry these out)	In part	In part	Yes
Demand management	Yes	Yes	Yes	n/a
Customer-side leaks	Yes	n/a	No	n/a

Below, we set out the key arguments associated with the allocation of each of the 'fringe' retail services and activities to either the retail or wholesale controls. Our recent discussion paper focused on the scope of retail services entirely from the perspective of the retail control for those contestable customers that will be eligible to switch supplier. We received four responses to our discussion paper – from Business Stream, Northumbrian Water, South West Water and Bristol Water. We have published these responses alongside this consultation.

Here, we consider the key arguments in relation to the allocation of each of these 'fringe' activities, including those for the non-contestable retail control covering customers that will not be eligible to switch supplier.

3.2 Where should we allocate the responsibility for providing the network calls service?

A ‘network call’ is a contact from a customer regarding a network issue. This includes things like low pressure or discoloured water.

There is already a range of different retailing arrangements with the water and sewerage sectors at the moment, some of which are particularly relevant to this consideration. For example, Yorkshire Water has separated it retail functions, which are provided by an associate company called Loop. Loop deals with minor operational calls and has access to the management and network monitoring tools of Yorkshire Water’s Integrated Customer Environment system.

Other companies also have additional layers of communications between themselves and their customers. Some water only companies, such as Cambridge Water, bill on behalf of the regional sewerage company. They also receive and pass on any operational calls that relate to sewerage services.

In Scotland, the processes that give effect to retail responsibility of network calls are set out in the operational code. There is a general principle that non-household customers will deal with their retailer rather than Scottish Water. This includes network calls, although it is recognised that following the initial point of contact subsequent contact may be direct between the customer and the network operator. In some limited cases and with the approval of the licensed provider, Scottish Water may make initial contact with the non-household customer.

3.2.1 Evaluation

Clearly, there are some advantages to allocating network calls to retail. By requiring the retailer to be accountable for all customer contact, including in relation to network enquiries, it would ensure that the retailer became a single point of contact for the customer. This would best enable the retailer to act as a champion for the customer and put pressure on the wholesale business to also improve the customer-facing outcomes it provides. For customers that cannot switch supplier, this would also help to apply a stronger challenge on the cost of these services, which would ensure that they were provided in the most efficient way.

Allocating responsibility for network calls to either the retailer or the wholesaler does not appear likely to have any demonstrable impact on either of our objectives to enable efficient investment or incentivise efficient water use. But it would most likely create a more complex market place between retailers and wholesalers in order to provide the benefits of a single point of contact for customers. The need for retailers to co-ordinate with wholesale network operators creates the potential for more complexity and transaction costs associated with the additional information exchange on network issues.

This information may already exist in some cases – for example, where one company bills on behalf of another. Here, splitting the control may make these exchanges more transparent from those that take place now. This could also improve efficiency. Similarly, there may also be new processes and mechanisms that the sectors could introduce to manage these exchanges more efficiently – this is precisely the purpose of the market and operational codes that would be part of a future competitive market.

What is likely is that there will be more complexity if network calls were allocated to retail. There is also likely to be some additional or different transactions and processes involved. There is a risk that this could result in 'double handling', which may be less efficient.

Consultation question

Q3 Please explain whether you think the responsibility for providing the network calls service should be allocated to the retailer or the wholesaler? Please explain the reasons for your preferred approach.

3.3 Where should we allocate the responsibility for providing, owning and maintaining meters and the meter co-ordination service?

There are two distinct services in the area of metering. These are the:

- service to install, maintain or replace the meter; and
- ownership of the meter as an asset (who would actually own the meter put in the ground).

Linked to these areas is the activity of meter reading, which, as we have explained previously, is assumed to be a 'core' retail service.

There are important differences between metering for non-household customers (who will have choice) and household customers (who will not). About 90% of non-household customers are metered, compared with fewer than 40% of household customers.

This means that for customers that have choice, the activity associated with the service of providing a meter will tend to be about maintaining, renewing or enhancing the assets. This includes, for example, installing automatic meter reading technology.

For customers that do not have a choice, the activity will generally be about a range of different situations, including:

- installing new meters as part of a particular package of solutions to address supply/demand balance issues;
- maintaining, renewing or enhancing existing assets;
- responding to a customer requesting a metered supply;
- metering on change of occupier; and
- metering for new developments.

All of these could give rise to different operational considerations.

In Scotland, metering arrangements were originally outside of the scope of the retail market. But in April 2012, some aspects of metering were included. Since then, the new connections process has allowed retailers to be able to choose (from a list of companies accredited by Scottish Water) which particular supplier will install a meter at the time of the new connection. From April 2013, it is intended that retailers will be able to choose one of the accredited metering companies to carry out other metering activities (such as replacement). The retailer may also become accredited and provide these metering services to its customers. Meter ownership remains with the wholesaler (Scottish Water), which provides metering units to the retailers or the accredited companies and also makes a standard payment to the retailer associated with the costs of installation.

In the energy sector, where licences have been formally split, there was a distinction between the responsibility to provide a metering service to customers and the physical supply of a meter to enable such a service to be provided. Suppliers (retailers) were made responsible for providing metering services to customers and given the scope to discharge these responsibilities by contracting to acquire the required meters in an open market.

The service of physically supplying existing meters to retail energy suppliers was allocated to the wholesale or network companies. These were regulated both as the owners of the existing stock and as suppliers (in the meter provision market) to retail businesses installing new or renewing old meters. In practice, this involved implementing a separate price control to cover meter provision services at the wholesale level. This allowed the retail businesses to pay only for the remaining wholesale services and avoid the associated metering costs where they contracted with other parties.

At the time, Ofgem (the economic regulator of the UK energy market) considered that this split could have a number of advantages, including greater customer choice and more innovation. But in reality, there were a number of difficulties with this approach, and metering remains a contentious issue within the energy sector. That said, a recent review by Ofgem found no fundamental flaws in the functioning of the relevant markets.

Some large retail energy suppliers (such as British Gas Trading) went to considerable lengths to support new metering entrants. They did this because they considered that a competitive upstream market for providing metering services would benefit their own retail energy supply business in the longer term by removing their dependence on a single wholesale supplier for these services.

More recently, the energy sector has begun a significant programme of introducing smart meters across the country. The fragmentation of meter ownership has been emphasised as a potential challenge to the efficient delivery of that programme.

3.3.1 Evaluation

Against our specific objectives for a separate retail control there may be advantages to allocating meter installation and maintenance services to retail, or at least ensuring that retailers can exercise some choice and flexibility in providing these services. In particular, metering is associated strongly with the kind of value added services that retailers may be able to provide in response to individual customer needs. The evidence from the Scottish retail market suggests that these services are crucial to delivering overall value for customers. Similarly, these services are also critical to maximising water efficiency and demand management objectives.

But given the importance of wholesale services in demand management, there are also arguments for locating meter provision services in this area, so that responsibility and incentives for supply/demand planning and demand management investments can be aligned. This is likely to be the case for non-contestable retail services in particular, where metering levels are expected to be about 50% at the time of the next price control. There remains scope to make significant new decisions in the meter provision area.

Also, without other mitigating action – including adjustment to regulatory incentives between wholesale and retail services – there may be disincentives for retailers to invest in new meters for customers that cannot choose their supplier. For these customers, unless they remain under the revenue correction mechanism, business revenue is maximised by selling more water at the retail level in the absence of the competitive market pressure that will drive retailers to do more for their customers. The risks of asset stranding are also far higher.

And if meter ownership became contestable or split, then any centralised meter installation roll out would most likely be more difficult and costly to organise in a given area without the economies of density associated with a single provider carrying out this activity. But a national roll out of technology such as smart metering is likely to focus on household customers – who will be supplied under this model by monopoly providers.

In our statement of principles, we committed to leaving all of the RCV in the existing assets in the wholesale price control – this should remove the risks of asset stranding for existing meters. But, to the extent that providing new and replacement meters represents a capital-intensive activity, there may be a case for also allocating the ownership of the metering assets to the wholesale price control, which will continue to be based on a return on capital approach.

Finally, it is clear that allocating meter provision services to retail could increase significantly the complexity of the retail market. It would be necessary to put in place operational arrangement to co-ordinate the commercial activities carried out by a number of parties and deal with risks around commercial interoperability. This increase in complexity would be more significant on the contestable side of the retail market. This is because in the non-contestable side of the market the retailer will continue to be the same entity as the wholesaler. So, existing systems for information exchange may be adequate to deal with these issues.

Consultation questions

Q4 Should the responsibility for meter ownership, installation, maintenance and replacement be allocated to the retailer or wholesaler? Please explain the reasons for your preferred approach.

Q5 Are there any other arrangements that we should consider? If so, what are they and why should we consider them?

3.4 What should be done about disconnections?

At present, the companies have a number of powers to disconnect customers. Some of these powers relate to network functions, such as the power to disconnect customers for the purposes of carrying out necessary works on their infrastructure or the power to disconnect customers at their own request. These functions, including permanent disconnections, are not the focus of this section, and are better understood in the context of the network calls discussion above.

What is relevant to the retail services definition is the power to disconnect customers for not paying their bills. But, because of specific legislative constraints, this activity is not relevant to non-contestable household customers. Nor is it relevant to a small number of specified contestable non-household customers. This is because the companies are prohibited from disconnecting these customers for not paying their bills.

In Scotland, temporary disconnections (for non-payment) were originally outside of the scope of the retail market. But this activity was included in part in April 2012. Retailers may now appoint an accredited company to make a temporary disconnection on its behalf (and to make reconnections following such a disconnection). As an agent to the retailer, this company will be able to receive a payment from the customer allowing it to avoid disconnection. By making this change, the Water Industry Commission for Scotland (WICS) considered that giving retailers choices for disconnections should increase competition in this area and reduce costs.

In the energy sector, unless the supply to a property is not needed for an extended period of time, disconnection is primarily used as a debt management tool. Debt issues are for retailers to resolve and so they control the disconnection process. They can avoid having to disconnect customers physically by moving them onto pre-payment meters. This helps to eliminate the risk of bad debt from that customer.

In other cases, the network operator will disconnect the supply physically at the request of the retailer. The network operator cannot reconnect that customer without the retailer's approval. These arrangements have seen very little change over time.

If retailers were given the power to carry out physical disconnections, there would need to be a mechanism in place to deal with any concerns from the network operator that related to works carried out by other companies. This may involve accrediting contractors and putting in place a protocol for informing the network.

Similarly, if retailers were given only the power to make the decision to disconnect customers there will need to be an agreed operational framework that sets out how the wholesale business will carry out the physical disconnection on the retailer's behalf.

The extent to which such responsibilities are allocated to retail would have legislative implications for customers that have switched to water supply licensees. At present, water supply licensees cannot carry out physical disconnections. Nor can they require the customer to be disconnected. Enabling them to do this would require changes to the legislation to take account of this.

3.4.1 Evaluation

In the water sector, household customers cannot be disconnected (except for temporary works). Because the companies use disconnection as a debt management tool for non-household customers, there is a strong case for allocating it to retail. This is in line with our objective to ensure the effective functioning of the retail market. Not providing retail with any role in this activity is not a sensible arrangement if the wholesale business no longer has any function connected with customer debt. This is because customer debt needs to be managed by the retailer but the retailer would not have the tools to do so.

So, the key issue appears to be the means by which a retailer could be able to disconnect a customer, and – in particular – the risks associated with allowing parties other than the network operator to carry out such works.

We think that there are three options that relate to the way this service is allocated.

- The first would be to allocate the service and the responsibility to the wholesaler. This would ensure that there was no risk to the wholesale assets associated with other contractors.

- An alternative option would be to allocate the service and responsibility to the retailer. This would ensure that the retailer retained strong control over disconnections in the event that a customer did not pay their bill. But the interaction with the wholesale network would need to be managed.
- A third option would be to allocate the responsibility for disconnection to the wholesale business, but for the retailer to instruct the wholesaler when a customer should be disconnected for bad debt reasons. This option might also make it possible to introduce a degree of contestability and choice into some aspects of these services, without placing the activity with the retailer.

Consultation questions

Q6 Should disconnection services be allocated to retail, or should it remain part of the wholesale price control? Please explain the reasons for your preferred approach.

Q7 Who should retain responsibility for disconnection and why?

3.5 Where should we allocate demand management services?

Usually, 'demand management' means providing services to customers to help them reduce their demand for water – for example, by using water more efficiently. There are strong links between metering and controlling customer-side leaks.

Water companies and water supply licensees have a statutory duty to promote the efficient use of water by their customers. But they choose to interpret that duty in different ways. Within integrated companies, the activities carried out to achieve demand management outcomes may often be shared between customer service, operations, and water resource departments.

One way in which many water companies meet this statutory duty is to give household customers free products, such as 'hippo' bags and low-flow shower heads to help them use water more efficiently. They also offer a range of services for non-household customers, including water audits and leak detection. These services can be free or paid for.

In Scotland, there is a statutory mechanism under section 29e of the Water Industry (Scotland) Act 2002 that allows Scottish Water to apply to WICS for its consent to depart from a charges schemes in respect of a non-household customer that has done something which reduces (or increases) the costs incurred in providing services to the customer's retailer. This could include retailers achieving sufficient demand-side efficiencies to make a material impact on the wholesale costs they incur – and being able to seek a reduction in the wholesale price to reflect this.

Demand management and water efficiency are areas where Scottish retailers have been able to differentiate the services they offer to customers. Business Stream – operating as a retailer in the Scottish market – reports that it has saved its customers £19 million by helping them to reduce their consumption.

In the energy sector, retailers have had energy restrictions imposed on them in the past. They were responsible for generating those efficiencies because they had the relationship that meant they could incentivise the efficient use of energy by their customers. Under the Energy Efficiency Commitment, gas and electricity suppliers were required to achieve targets between 2005 and 2008 for promoting improvements in domestic energy efficiency. This was superseded by the Carbon Emission Reduction Target, which has the primary aim of cutting greenhouse gas emissions by 12.5% below 1990 levels by the end of 2012.

Allocating demand management services to retail or wholesale would have operational implications in relation to water resources planning. In carrying out this planning, the companies take account of demand management activity such as metering. Indeed, in some cases they seek to rely on this to the extent that they are able to avoid a new supply scheme.

Allocating demand management services to retail could require the retail business to be involved in that planning, or at least to be incentivised to take into account the impacts of their activities on wholesale supplies of water. Similarly, for those customers that are not eligible to switch supplier, there may be a disincentive for retailers to carry out demand management activity where retailers are subject to a strong efficiency challenge under the price control, unless their wholesale costs reflected the outcomes of demand management services provided to customers.

Allocating demand management services to wholesale would give rise to some practical implications associated with a much lower level of customer interaction. The mechanism by which a wholesale business could communicate with retail customers is not clear and would need to be set up.

The duty to promote the efficient use of water by their customers refers only to the integrated water company as a whole (the ‘undertaker’). It does not differentiate between parts of the business. Whether demand management services sit with the retail or wholesale parts of those businesses, both parts of the business will still be part of the integrated water company and will still be covered by legislation.

3.5.1 Evaluation

Allocating demand management services to retail appears to produce some advantages consistent with our objectives for separate price controls. In particular, the desire to maximise the incentives for demand management is consistent with retail-led demand management. This is because the effect of demand management will be to reduce a customer's bill in the contestable market. Typically, this is a clear imperative of a retail business seeking to collect and retain customers.

But on the non-contestable side there would need to be mechanisms introduced to ensure that there was no disincentive to provide these services to customers as a result of an average cost to serve efficiency challenge.

There does not appear to be any effect of allocating the activity either to wholesale or retail on objectives to enable efficient investment, other than the ability of a wholesale company to take account of and rely on demand management within water resources planning where that activity is not carried out by the retailer. Allocating the responsibility to the retailer could again create a (relatively smaller) requirement for information exchange and complexity between the two parties. But this information exchange is likely to be required anyway if and when the UK Government's proposals for retail competition are introduced.

Consultation question

Q8 Should the responsibility for demand management services be allocated to the retailer or the wholesaler? Please explain the reasons for your preferred approach.

3.6 Who should be responsible for customer-side leaks?

These services relate to work the companies carry out to repair leaks that are the customer's responsibility to fix. These services are discretionary in that they are not required or controlled as part of the regulatory or legal framework. But in general, under the existing integrated price control, the relevant activities have been funded – at least partially – as part of the base service operating expenditure where companies have chosen to offer free repairs. So, the associated services are a relevant consideration for allocation in future split price controls.

In Scotland, this service was defined as retail. This is because tackling customer-side leaks was seen as a central part of the wider set of services that retailers can offer. Evidence suggests that this approach has delivered savings to customers.

In the electricity sector, there is no direct equivalent to a ‘leak’, but retailers are responsible for dealing with the theft of electricity (non-technical losses) because they are responsible for paying the network operator for electricity consumed. This is not a ‘leak’ in the usual sense, but is a way for the product in question to leave the network and not be paid for.

In the gas sector, the network business is responsible for stopping leaks on customers’ pipes – primarily because leaking gas is a safety issue. If the repair can be completed within 30 minutes, it will do the work for free. If it takes longer, the network business will make the leak safe by shutting off the supply, but then it becomes the customer’s responsibility to make the repair.

Allocating demand management to retail or wholesale would have operational implications in relation to leakage targets and water resources planning. Supply pipe leaks that are customers’ responsibility represent a considerable proportion of overall leakage. For some companies, the repair schemes in place to deal with them have a significant impact on their water resources planning. As with demand management, the practical implications for this activity relate to sharing information between retail and wholesale. They also relate to the distance created between wholesale and the customer interface.

3.6.1 Evaluation

There are advantages in allocating these services to retail that are consistent with the objectives of a separate price control. A key consideration in this area is the overlap between these activities and the promotion of plumbing, drainage and supply pipe insurance schemes. So, these schemes may be an important part of a retailer’s value added services.

But there may also be disincentives for integrated retailers to provide these activities to non-contestable customers under an average cost to serve efficiency challenge. This would need to be considered and addressed, including in the design of the respective incentives of the retail and wholesale controls. Similarly, the activity may create the need for information exchange between the retail and the wholesaler on the contestable side.

Another key issue appears to be the interaction with water resource management planning and the ability of a wholesale company to take account of and rely on demand management within water resources planning where that activity is not carried out by the same company.

Consultation question

Q9 Should services relating to customer-side leaks be allocated to retail or wholesale, or is there an alternative arrangement that we should consider? Please explain the reasons for your preferred approach.

4. Allocation of costs

We have been working with the incumbent companies on our accounting separation project since 2009. They have now published two years' of information for nine elements of their businesses – or 'business units'. One of these business units covers retail services. Here, they have split this information between household and non-household customers.

Through this work, the companies have told us that there is not always a 'right way' of allocating costs. They emphasised that different systems, structures and circumstances mean that while one approach may be appropriate for one company it may not always be appropriate for all companies.

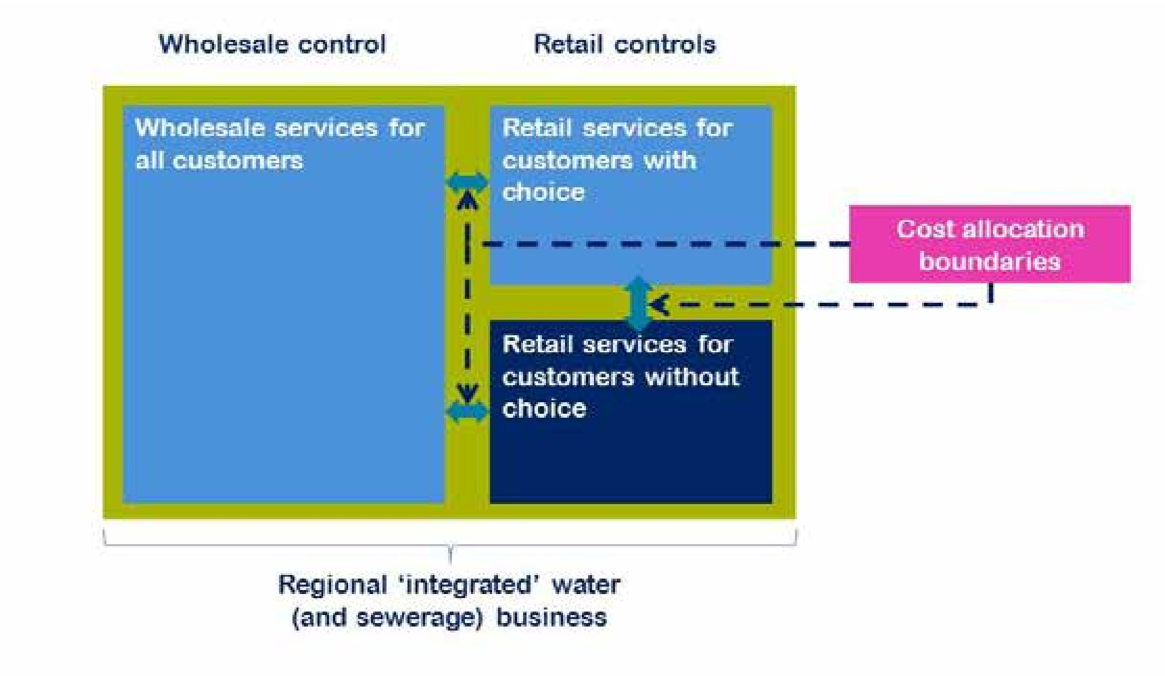
A mixed group of respondents to our future price limits consultation also raised the issue of cost allocation, giving a different view. Some suggested that for these separate retail and wholesale price controls to be effective more common and consistent cost allocation mechanisms were needed. Others suggested that an independent review of cost allocation mechanisms should be carried out, and that Ofwat should publish more prescriptive guidance on cost allocation procedures.

To date, the companies' separated accounting information has formed part of their annual regulatory return to us (the 'June return'). In previous years, we have used this information to monitor whether the companies were fulfilling their obligations and meeting the obligations of their price review settlement.

But in line with our new approach to regulatory compliance, we will no longer require the companies to submit their June returns. Instead, we have asked the companies to submit a risk and compliance statement and publish a suite of key performance indicators. This includes information on how they have allocated their costs. We will also be consulting separately about formally requiring the companies to include this information in the audited regulatory accounts that they submit to us each year.

The controls we set will at the next price review comprise a range of different services and activities. In several instances, this will require costs to be apportioned across these three areas. So, there are two critical boundaries where costs could be allocated differently – between the wholesale and retail elements and also between the contestable and non-contestable retail elements. These are shown in the diagram below.

Figure 1 Cost allocation boundaries



4.1 Why is the consistent allocation of costs important?

Based on the boundaries suggested, it would be possible for costs to be allocated differently between the wholesale and retail elements of the value chain, or the contestable and non-contestable retail elements – or, indeed, both. This would mean that some companies may have retail costs that appear lower or higher than others, even if they are not more or less efficient than others.

If individual companies allocated costs differently, in a way that made their retail costs appear higher than other companies, then this could impact on both the contestable and non-contestable retail price controls they faced. Under the non-contestable retail control the company would appear to be less efficient than other companies. So, it may be made to find a higher level of efficiency savings relative to those other companies even though they may not be less efficient.

Similarly, its contestable retail services would not be offered on a consistent basis to those of other companies and there would not be a level playing field. The company would find that its retail operation appeared less efficient than others. The result of this is that the company would be unable to offer the same attractive prices to customers as its competitors. So, more customers may choose to switch to an alternative provider.

Because of this, there may be an incentive on companies to allocate costs more heavily to those business units that make up the wholesale price control. This approach would ensure that their retail operations appeared to be more efficient. In turn, this might then result in those companies receiving a less strong efficiency challenge to their non-contestable retail costs while their contestable retail business would also appear to be efficient relative to other providers, allowing it to compete more effectively with entrants.

This cost allocation issue has been a significant concern in other utility sectors and during the liberalisation of the energy market Ofgem reallocated an equivalent of 18% of distribution costs back to retail following the misallocation of these costs by companies to the network elements of their businesses.

The UK Government's Water White Paper sets out plans to extend the scope for competition significantly in the future, with all non-household customers in England expected to become eligible to choose their retail supplier. This makes it essential that we ensure correct allocation of costs as early as possible if we are to meet our principle of future proofing the regulatory arrangements to further changes.

4.2 How are we addressing cost allocation concerns?

We recognise the significance of these concerns and we must be confident that any future retail price controls are set on a robust basis. There is clearly a risk that without effective and consistent cost allocation mechanisms between companies there could be impacts on those customers that cannot choose their supply – and also on those that can.

To address these issues, we need to develop a more thorough understanding of how significant this issue is and how many companies are affected. The companies will publish their latest accounting separation information in July. As part of that, we have asked them to provide a methodology statement setting out how they have allocated these costs to help us assess the scale and nature of the cost allocation risk. At that point and in line with our risk-based approach to regulation, we will consider any action that may be necessary to mitigate this risk and improve the consistency of cost allocation among the companies. We will publish a short review of companies' separated accounting information and set out within it any action that we intend to take to address these cost allocation issues.

Consultation question

Q10 Do you agree with Ofwat's proposed approach to considering and addressing cost allocation issues? If not what other approach should be taken and why?

5. Moving to wholesale and retail controls

Since privatisation in 1989, Ofwat has set a single price control for all of the services that each of the regional monopoly water and sewerage and water only companies provides to customers. At the next price review in 2014, we have committed to setting different controls for wholesale and retail services.

Introducing a separate wholesale control for each company will support the objectives of our future price limits project, including continuing to enable efficient investment. We intend to continue to set the wholesale control using a methodology that gives companies and their shareholders a return on the capital assets they hold, using the existing regulatory capital value (RCV) approach. We have also committed to indexing the wholesale control at the Retail Price Index (RPI).

Our approach will allow us to protect all of the existing capital investment made in these assets from any risk that they will become stranded. This is because all of the RCV will be allocated to the wholesale control regardless of whatever decisions are taken on the scope of services that should be allocated to the retail price control.

A separate wholesale control will allow clear charging boundaries to be established between retail and wholesale services. This will support transparent wholesale prices for:

- the existing retail operations of the incumbent companies; and
- other new entrant retailers which would be buying the same wholesale services to serve their customers.

This will do two things.

- It will help ensure that potential entrants wishing to compete are clear about the charges they will incur.
- It will also help to encourage more players into the market and lead to greater rivalry and choice for customers, particularly when – as is expected – the proposals in the UK Government's Water White Paper mean that all non-household customers in England will be able to choose their supplier.

A separate retail control will also focus the attention of the management of existing incumbent companies on customer-facing retail services. This will encourage them to better address issues such as bad debt and improve levels of customer service.

To make the transition from a single vertically integrated control to separate controls for wholesale and retail services, we need companies to split their charges. In particular, companies will need to set separate charges for wholesale services and for retail services. This is necessary so that we can ensure that companies do not earn more than what they are allowed under the respective wholesale and retail controls.

One outcome that could arise when companies split their charges is that it might reveal that some charges are not cost reflective. This situation could arise because there would be greater transparency about how companies recover the cost of retail and wholesale services from different customer groups. It follows that this process could better reveal cross-subsidies between customer groups compared with the current arrangements.

Any attempt to rebalance charges during the transition to separate price controls, could create both winners and losers. This is referred to as an incidence effect. We know that customers would not appreciate any significant and unexpected shifts in their bills. So, we want companies to limit any incidence effects when splitting charges into retail and wholesale components at the next price control. This is also in line with our evolutionary approach to reform.

5.1 Interaction between the retail and wholesale control

An important consideration when setting separate retail and wholesale charges is the interaction between the two controls. In particular, we need to consider the extent to which wholesale costs can simply be passed on to end customers. This was a significant area of concern for respondents to our future price limits consultation.

Existing retail tariffs include wholesale costs and, while we expect retail entrants will challenge the wholesale business to reduce its costs on behalf of their customers, there will be limits to the level of influence retailers can have over the wholesale charges that it faces. For example, if a water company carried out a major investment programme on the network, then this may raise the wholesale charges offered in that region. Retailers would have limited influence over these costs and this means that wholesale charges would need to be passed through in retail tariffs.

In our future price limits consultation, we suggested that tariffs for contestable customers could be calculated as a gross retail margin above wholesale prices. This might be expressed as the wholesale charge plus £25 for a particular tariff. The result is that any changes in wholesale charges could be taken into account in default tariffs automatically. We also suggested that base year wholesale charges could be passed through to form part of a revenue requirement for the non-contestable price control.

The structure of the two retail controls are illustrated in the figure below.

Figure 2 Elements of retail price controls

For both of these approaches, we propose that the retail caps are expressed by reference to the prices of previous years. In light of the UK Government's Water White Paper, we recognise that the scope of the contestable retail price control is likely to change considerably during the price control period as choice is extended to about one million additional non-household customers. We also expect the Welsh Government to publish a water strategy later this year setting out its position. We will address this issue in our consultation on the 2014 price review methodology, which we will publish in the autumn.

Consultation question

Q11 Do you support our approach to passing through wholesale costs? If not, what alternative approach would be more suitable, and why is this superior to our proposed approach?

6. Price controls for customers with no choice

In our statement of principles, we said that we would use an average cost to serve approach to regulate the retail prices in the non-contestable market, as a proxy for the costs of an efficient retailer. In this chapter, we consider some of the options associated with developing this approach, including:

- **arithmetic issues** – such as what **denominator** we should use to calculate the average cost to serve and whether we should use a **weighted or unweighted** average across the sectors;
- **impacts on customers** – such as making sure that bills do not rise for customers of **efficient retailers** with costs below the average cost to serve;
- how we should deal with adjustments to the average cost to serve; and
- whether we can address any problems of **weakened incentives**.

We are carrying out a piece of work jointly with United Utilities that is considering options for addressing these issues. We will present the draft findings of this project and seek stakeholders' views at a workshop on 16 July.

6.1 Arithmetic issues in calculating average cost to serve – the denominator

In our future price limits consultation, we calculated the average cost to serve for water and sewerage companies and water only companies separately using historic data for illustrative purposes. This is because there are clear differences between providing retail services for water only, and for water and sewerage. We considered that using 'properties billed' as the appropriate denominator for deriving the average costs needed in order to provide retail services – it is a better cost driver than volume of water sold or other factors for the costs of the specific retail services concerned.

Respondents to our consultation were concerned that using 'properties billed' would disadvantage companies that provided both water and sewerage services to customers, compared with those that only provided water services.

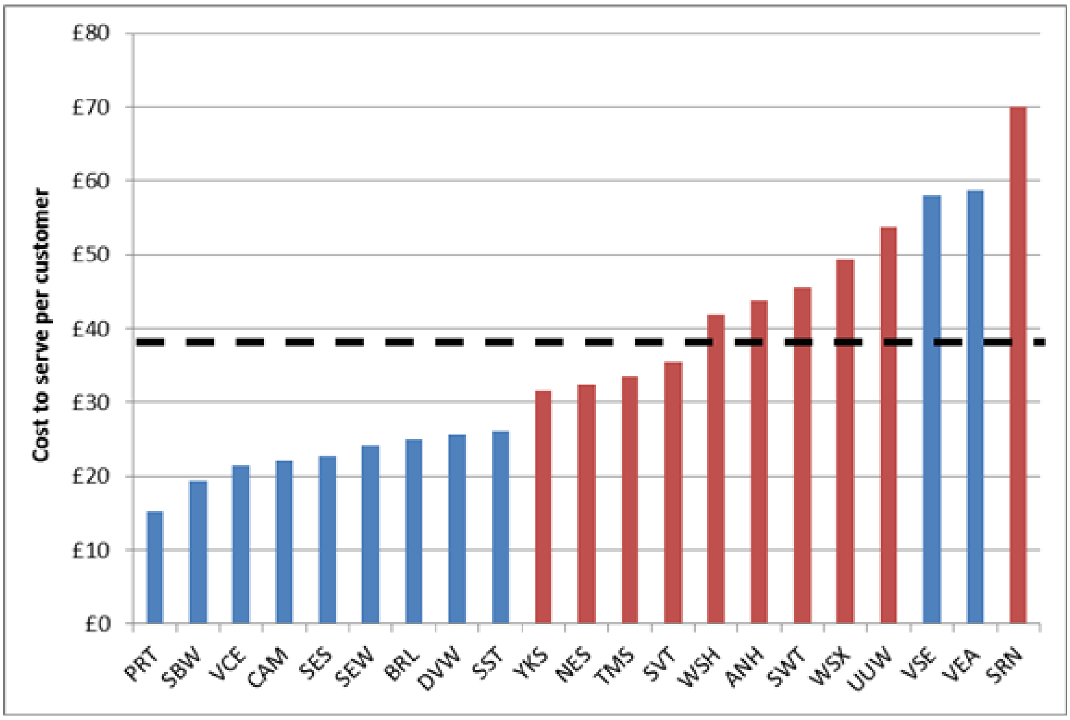
We are also concerned that the way the average cost to serve is calculated for regulatory purposes may impact both on customers' bills and companies' profits. We will need to consider these incidence effects in deciding on a methodology.

The graphs that follow compare indicative average costs to serve for each company based on the most recent accounting separation information for household customers. In turn, this information in turn is based on the activities set out in table 2. In all cases, we have calculated an unweighted average. This is based on calculating the average for each company and then calculating a collective industry average based on these. It would also be possible to calculate the 'weighted' average – we explain these alternatives in the next chapter.

6.1.1 Option 1

In our future price limits consultation, we proposed calculating the average cost to serve by dividing the total retail costs for each company by the **number of households billed for water**. This is shown in Figure below. This approach works well for water only companies, but water and sewerage companies would most likely face some additional costs in billing for both services.

Figure 3 Average cost to serve per water customer billed – one average



Source: Ofwat's analysis of companies' accounting separation data 2010-11.

The graph shows that water and sewerage companies (highlighted in red) have a higher average cost to serve when we use ‘households billed for water’. This is likely to be because of the extra retail costs they incur for also providing retail sewerage services.

One of our objectives for the non-contestable retail control is to deliver better outcomes for customers by challenging these monopolies to improve. We think that using ‘households billed for water’ would be unfair for companies that also have sewerage customers, given the wider scope of costs that they must incur.

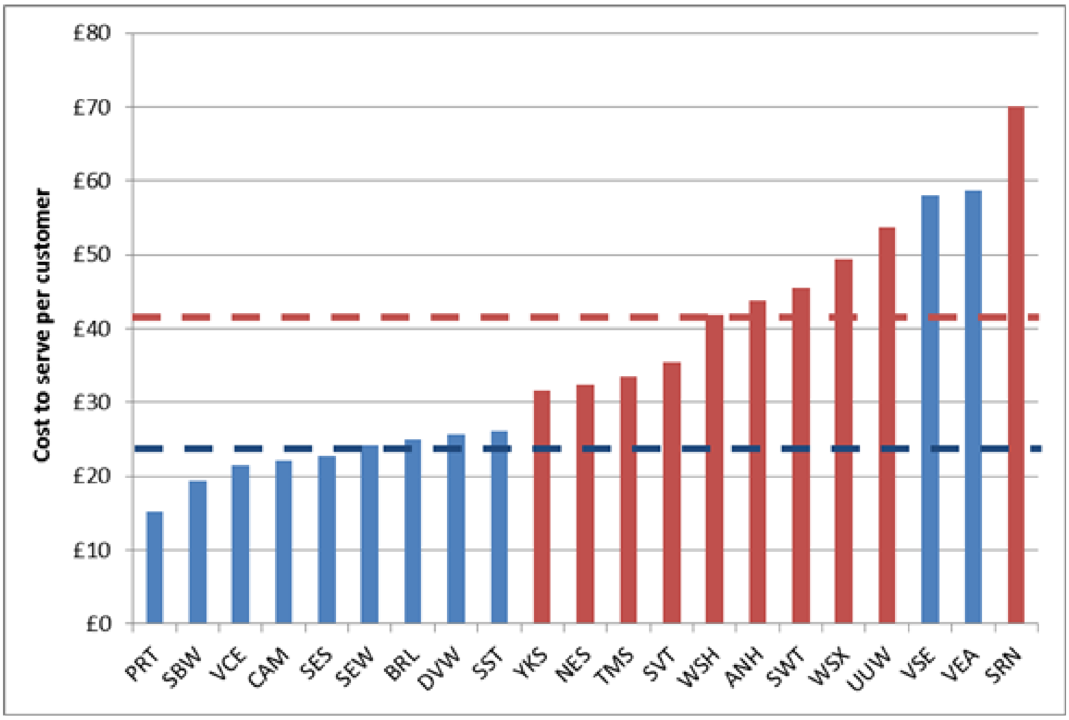
6.1.2 Option 2

Under this option, we could apply **two different average costs to serve** – one for water only companies, and one for water and sewerage companies. We illustrate this in figure 4 below. This was the approach we took in the impact assessment that accompanied our future price limits consultation.

But there are problems with this approach as well. No water and sewerage company bills exactly the same number of customers for water and sewerage services. Some companies, such as Southern Water, have significantly more sewerage customers (1.7 million) than water customers (950,000), with water only companies providing water services in part of the area they serve for sewerage.

This approach would also not compare all companies, which suggests that we might not be comparing all companies with the best performers. This means that using ‘households billed for water’ as a single denominator for both averages could disadvantage those companies with more sewerage customers than water customers.

Figure 4 Average cost to serve per water customer – two averages



Source: Ofwat's analysis of companies' accounting separation data 2010-11.

6.1.3 Option 3

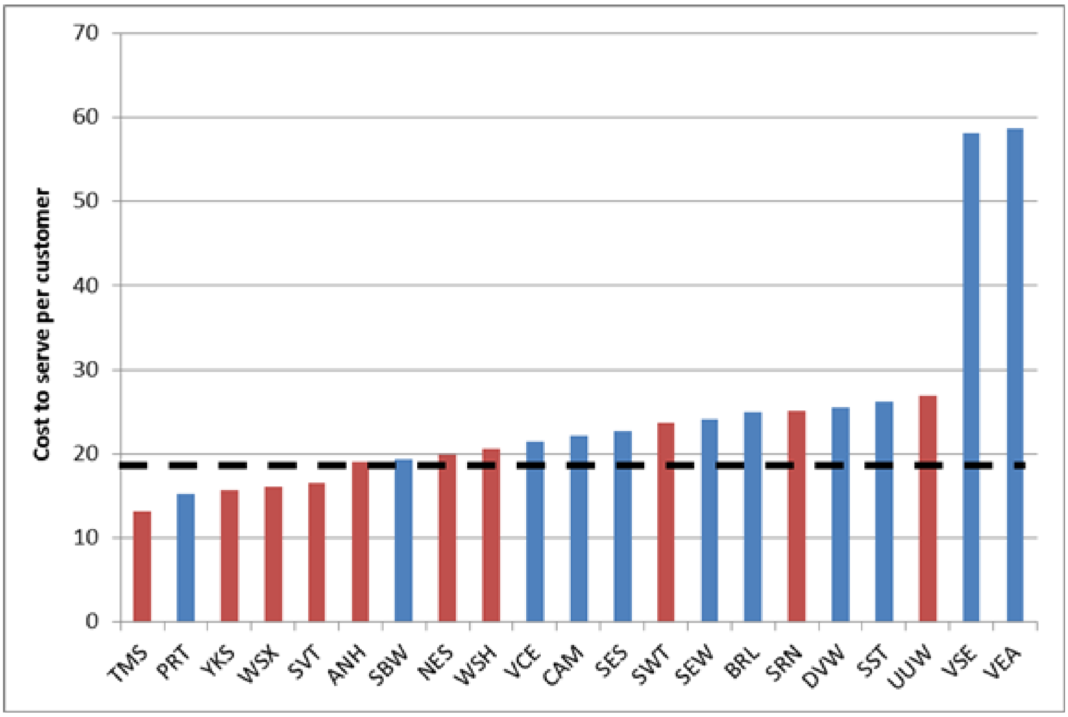
To help remove this disadvantage, we could use **'households billed for water' plus 'households billed for sewerage'** as a separate denominator. We illustrate this in figure 5 below.

Although this removes the problem of disadvantaging water and sewerage companies with different numbers of sewerage only households, it may go too far the other way and instead disadvantage water only companies. It assumes implicitly that:

- the cost of serving water and serving sewerage customers for retailing is the same; and
- there are no cost savings for supplying water and sewerage retail services together (scope economies).

It seems likely that neither of these assumptions is entirely accurate. This is because some costs are shared across both services (for example, billing); and sometimes, one service relies on costs incurred in the other (for example, meter reading).

Figure 5 Average cost to serve per household (water and sewerage)



Source: Ofwat's analysis of companies' accounting separation data 2010-11.

6.1.4 Option 4

One solution to this problem may be to **develop an adjustment factor** that reflects any economies associated with providing both services. This could estimate the economies of scope from billing for both services. We could then apply three distinct average costs to serve:

- water only;
- sewerage only; and
- water and sewerage retail services in combination.

This option may be a fairer way of applying an efficiency challenge across all companies, as it explicitly takes into account the costs of supplying water and sewerage customers together. This means that it may also give a stronger incentive for companies to adopt the most efficient approaches to billing – for example, continuing arrangements to bill for water and sewerage together where this is more efficient.

But this option is more complex to calculate, and we may have difficulties in separating the impact on retail costs because of economies of scope from those arising from underlying differences in productive efficiency between companies.

We think **option 4** may be the best approach, as long as we can resolve the calculation issues described above. This is because it is effective at protecting customers without unfairly penalising particular companies with our efficiency challenge.

Consultation question

Q12 Please explain whether you agree that we should calculate the denominator based on the number of customers billed, with an adjustment to reflect the economies of scope associated with billing both water and sewerage services? If not, please explain what alternative options we should consider and why.

6.2 Arithmetic issues in calculating average cost to serve - weighted or un-weighted averages

There are also other ways in which we calculate the average cost to serve that could affect companies and customers. One of these is the way that the averages are calculated. There are two options for doing this.

6.2.1 Option 1

This approach involves calculating the average cost to serve for each company, and then taking the simple arithmetic average of these (the **unweighted average**). It is less influenced by the costs of the few largest companies. This is a particular concern when the three largest companies account for more than 40% of the retail costs in the sectors as a whole.

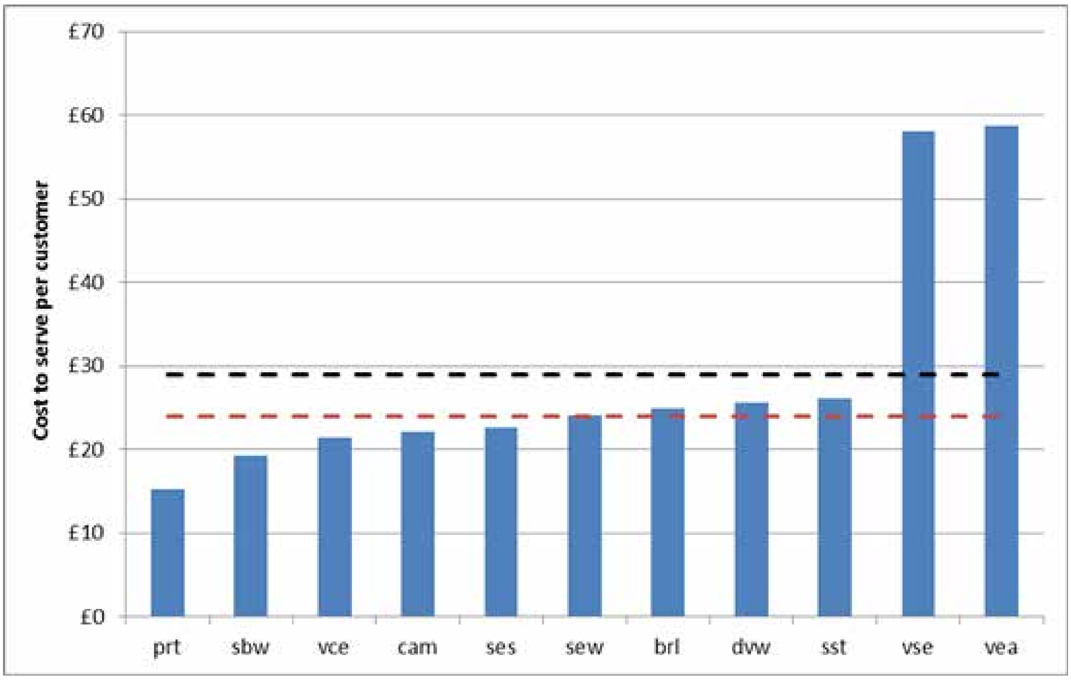
This approach is simple – the average cost to serve would be the actual retail costs for one company, which we could use as a benchmark for the others. It also provides a more effective efficiency incentive as the efficiency challenge for individual companies is influenced by the behaviour of other companies a more balanced way. So, this approach is closer to the existing frontier-based form of regulation.

6.2.2 Option 2

Under this approach, we would calculate the total cost across all companies and divide this by the total number of properties served (the **weighted average**). This approach is more of a true average cost of serving customers across the sectors as a whole, but is heavily influenced by the policies of a few companies. Figure 6 below shows that the weighted average for water only companies (highlighted in red) is lower at £24 than the unweighted average (highlighted in black) at £29. This emphasises the significant differences that occur between the two approaches because of the:

- substantial dominance of a much smaller number of large water and sewerage companies; and
- number of properties that they serve which drives the (weighted) average.

Figure 6 Comparing weighted and unweighted averages for water only companies



Source: Ofwat's analysis of companies' accounting separation data 2010-11.

We think that **option 1** is the most appropriate way of calculating an average. It is less dependent upon the costs of a few companies and provides a more effective efficiency incentive as the efficiency challenge of individual companies is influenced by the behaviour of other companies in a more balanced way.

Consultation question

Q13 Please explain whether you agree with our preferred approach to calculate average retail costs based on an unweighted average? If not please explain what alternative options we should consider and why.

6.3 Applying an average cost to serve

In our future price limits consultation, we proposed a single average cost to serve as the basis for setting price limits, in addition to wholesale costs – allowing companies to recover that much retail revenue from bills to non-contestable retail customers. This would require very little information to be collected from companies beyond what they will already provide in their regulatory accounts, and so would represent an approach with a low regulatory burden.

We proposed this approach because we considered that it could create incentives for efficient retail operations, since higher than average costs cannot be recovered from customers in their prices. We thought that a stronger basis for an efficiency incentive would be to use the lowest cost to serve as the benchmark. But we said we would not do this for the next price review in 2014 because we considered that this could be too significant a change on companies' retail operations in the short term.

Respondents raised some concerns about this approach – they considered that it could create both winners and losers among companies and customers. There is a risk that companies with retail costs that are currently below the average could raise prices without any increase in service levels, while those above the average may face a significant efficiency challenge without a glide path to address it.

We think there are two possible ways to address this problem.

6.3.1 Option 1

Under this option, we could apply the **average cost to serve as an upper limit for each company's own price caps** – so more efficient companies would use their cost to serve as the basis for their own price caps instead of the average. This would mean that companies with an average cost to serve below the industry average are not able to raise their prices above the levels implied by their own retail costs.

This approach supports our objective of protecting customers, as there seems to be no reason to allow companies that are already able to provide retail services at existing prices to increase those prices. But it would be a less simple option than applying an overall average cost to serve.

6.3.2 Option 2

With this option, we could apply a cost to serve challenge **based on the most efficient costs**. Previously, we have said that we would not do this for the next price review. This is because we think this would represent too big a step for companies' retail functions. It may also impact on the ability of the overall business to finance its functions.

In any efficiency challenge there is also a question about how robust the data is on which that challenge is based. At the last price review in 2009, we only challenged companies' operating costs on the basis of 90% of the difference for water between the frontier company and other companies, and 80% of the difference for sewerage operating costs. This reflected the reliability of the data (after 20 years of applying this approach). The existing data on which this challenge would be set is, as we have noted, immature. As a result, it is subject to a degree of inaccuracy.

Although we have not ruled this out for future price reviews, we consider that this approach would not be appropriate at this time.

Consultation questions

Q14 Please explain whether you think we should apply the average cost to serve as an upper limit for each company's price caps or whether we should apply a cost to serve challenge based on the most efficient costs?

Q15 Are there other options we should consider? If so, what are they and why should we consider them?

6.4 Adjustments to the average cost to serve

Respondents to our future price limits consultation raised a number of concerns about making adjustments to reflect differences in cost for company-specific factors. They thought we should adjust for:

- levels of metering; and
- bad debt or some measure of deprivation.

Companies considered that these issues:

- influenced their retail costs significantly;
- were beyond their control; and
- that adjustments should be made to reflect them.

In our consultation, we said that we do not want to adjust for differences that are the result of inefficiency. If we adjust for too many factors, there is a risk that the simplicity of our incentives is lost and it may not be clear how (and why) we have chosen to make certain adjustments.

At previous price reviews, we have allowed a number of special factor claims in these 'retail' areas, and currently recognise some differences within our charges approval process (see appendix 1).

We think that we should use the following principles in deciding whether or not to make adjustments.

- The impact of the factor must be material.
- The factor must be outside of a company's control.

These principles would ensure that we do not make adjustments for differences as a result of inefficiency and only for factors that are beyond the control of a company's management.

It may be difficult to assess whether some factors are outside of a company's control, or the result of that company's approach – for example, efficient recovery of bad debt. As at previous price reviews, it would be up to companies to provide compelling evidence that they have met these two criteria.

Consultation questions

Q16 Please explain whether you agree with our preferred approach to only make adjustments to the average cost to serve if (i) the impact is material; and (ii) the factor is outside a company's control? If not, please explain your preferred approach.

Wherever we do make adjustments, there is a strong case that these should be made on the basis of efficient costs. This would imply that any adjustment factor should be calculated on the basis of an industry-wide assessment rather than the assessment of individual companies.

Similarly, there is a strong case for applying any adjustment to all companies (two-sided adjustments). This is important for incentivising all companies to improve efficiency because a particularly efficient company may face a weaker efficiency incentive if it is not subject to an adjustment but its less efficient neighbour is.

So as an example, this would mean that if a company has factors outside its control that suggests high levels of bad debt, but it has an efficient approach so does not actually have higher costs for bad debt, then we would make an adjustment in the same way as we would for a less efficient company with high levels of bad debt and high costs of bad debt.

But there may be a case for applying one-sided adjustments if the average cost to serve challenge was applied in a way that did not place a strong efficiency challenge on those companies with costs below the average. This is because if adjustments were two-sided in this scenario those companies with costs below the average would likely receive even higher windfall gains.

Consultation questions

Q17 Please explain whether you agree that where we make adjustments, they should be on the basis of efficient costs.

Q18 Please explain whether you think such adjustments should one-sided or two-sided and why.

6.5 Impact on incentives

In response to our future price limits consultation, some companies argued that the average cost to serve approach would affect their incentives to do certain things, including:

- introducing more metering;
- developing social tariffs, and
- providing water efficiency services.

They considered that these could also affect those companies performing above and below the average differently.

In line with our proposed principles for adjustments, we need to understand the extent to which these disincentives would exist and whether their effects would be material. But subject to this work being carried out, we consider that there are a number of options we could use to address any incentive problems that might exist. We welcome stakeholders' views on these early proposals.

6.5.1 Option 1

The scope of retail can affect incentives in a positive or negative way. For example, if we found that average cost to serve did have a negative effect on the incentives that companies faced to provide water efficiency services, then we could choose to allocate these services to the wholesale price control. This would require any disincentive effects to be weighed up against any advantages of allocating water efficiency services to the retail price control.

So, in order to provide wholesale services efficiently, an integrated regional company may plan to introduce universal or increased levels of metering across households in its area to reduce the amount of water it needs to supply. The retail service would have no incentive to introduce more meters, other than to help provide a better service to its customers. Nor would it be compensated for doing so under a straight average cost to serve approach without some compensating incentives because there would be little positive impact on its revenues. This means that the service of providing meters could be left in the wholesale business, which may face stronger incentives to introduce them.

Leaving some affected services in the wholesale business might represent an obvious way of dealing with the potential problems of inappropriate incentives within the retail control. But this could cause other problems, particularly as similar issues do not arise in the contestable market where metering is already widespread, and where retailers have a much stronger incentive to provide a wider range of valued services to customers in order to retain them. For non-household customers, there may be other reasons why meters should be included within the scope of retail services – for example, the ability for retailers to offer more innovative, demand-based tariffs. Similarly for non-contestable household customers, because they would still be served by an incumbent monopoly licensee, they would still be subject to any obligations around demand management.

As we explained in chapter 4, having a retail service definition that was different for both household and non-household customers would require two sets of wholesale charges, which would add additional complexity.

So, allocation of services could therefore have some significant problems in aggregate, particularly for the development of wholesale charges. For some incentives, this might be more feasible than others. Any adjustment we made would need to reflect a consideration of the efficient level of providing the service. This may be different from the case-by-case assessments of the past.

6.5.2 Option 2

Under this option, we could separate out certain costs that may be related to any disincentive issue and apply the average cost to serve challenge to those **'fixed' or 'normal' retail costs**, such as billing costs. For those costs that vary according to the decisions companies make about thing like metering, water-efficiency advice or social tariffs – and where we may be concerned about disincentive effects – we could apply a different approach, such as allowing an efficient amount of cost on top of the 'fixed' or 'normal' elements.

Essentially, this would involve partially customising the price caps for each company, along the lines discussed in relation to the wider approach above.

6.5.3 Option 3

If we thought that the impact on incentives was material, we could make adjustments for new metering investments or water efficiency advice within the retail control directly.

For example, if including metering provision services within the retail control was a barrier to introducing metering and water efficiency measures, we may be able to allow additional revenue within the non-contestable retail control for those activities carried out in relation to these demand measures. Depending on how it was applied, this approach could be similar to option 2.

Since the wholesaler and the non-contestable retailer will remain vertically integrated, the cost-benefit case for demand measures could apply to the whole business – not just one activity. The purpose of separating allowed costs for price control purposes would be to focus incentives on the different services concerned. This would have the potential of bring about market transition when some of these services became more contestable during the price control period as envisaged in the UK Government's Water White Paper proposals.

This helps to meet our objective of supporting incentives for demand management – it allows companies to include some demand-side measures associated with their water resource management plans within the retail business unit. It could also help to protect customers because although the retail costs may increase, the wholesale prices should decrease by more if the demand management measures are cost-effective overall. We would only expect to make such adjustments where costs are material.

6.5.4 Option 4

If we wanted to leave the responsibility for providing the service with the retailer, but would prefer costs to be managed alongside the other costs required for services covered by the wholesale control, it may be possible to pass certain costs through from the wholesale control.

For example, the wholesale business could own the water meters and maintain a list of approved suppliers. If a contestable retailer wanted a different meter, it could select from the list and pay the wholesaler for the service of providing the meter as part of the wholesale prices subject to the wholesale control. This would leave the retailer free to make arrangements with the customer to recover the costs of the meter.

This is similar to the approach adopted in the Scottish contestable retail market. It could protect customers by placing competitive pressure on the installation costs of meters – and by supporting more innovation and customer choice in the selection of meters.

Different incentives may be handled more appropriately using different approaches. In developing our price control proposals for consultation in the autumn, we will need to think carefully about how we ensure these incentives are not weakened in the context of considering how the wholesale and retail controls work together for integrated companies.

Consultation questions

Q19 Please identify and discuss if there are any services that are retailer might have a lower incentive to deliver on account of an average cost to serve efficiency challenge. For each service, please explain how material the issue is using evidence to support your answer.

Q20 How should we address these issues?

We recognise that we have not discussed all stakeholders' concerns at this stage. In particular, we have not considered here whether or not retail controls and an average cost to serve price cap should be indexed or whether a margin should be included. We will consider these issues in our consultation on the methodology for the 2014 price review, which we will publish in the autumn.

7. Price controls for customers that will have choice

In our future price limits consultation, we considered the issue of setting default tariffs for contestable customers. A default tariff aims to protect customers from excessively high prices immediately after market opening when entry barriers may remain relatively high. It is likely to be a particular concern for smaller customers.

Default tariffs will need to reflect the efficient costs of the retail activities, as well as allowing for a reasonable profit margin. Once the market is operating effectively, we will need to consider removing the safeguards afforded by the default tariff and associated service standards.

We said that the tariff would represent a defined level of service for a defined price; and that all market participants would be required to offer the tariff. Market participants will still be free to offer alternatives to the default tariff with different levels of service.

In general, respondents supported the idea of default tariffs. But they raised particular concerns about:

- how we would move to a default tariff from existing tariffs;
- default service levels;
- indexation; and
- the overall structure and design of the tariff in particular.

In this chapter, we consider some of the options associated with the development of the default tariff, in particular:

- how **prescriptive** we should be in setting default tariffs;
- what **principles** we should follow, if we consider this the most appropriate approach;
- how we should **structure** default tariffs;
- how we should **migrate customers onto the default tariffs**;
- whether we should require all **market participants** to offer default tariffs;
- whether default tariffs should apply to **all customers**; and
- the **service levels** we should apply for default tariffs.

We are carrying out some work jointly with Thames Water that is considering options for addressing these issues. We will present the draft findings of this project and seek stakeholders' views at a workshop on 16 July.

7.1 How prescriptive should default tariffs be?

We would prefer not to set a revenue requirement for contestable customers. Instead, we would express default tariffs as a 'gross retail margin' above wholesale charges. We could do this in several ways, depending on how prescriptive we want to be.

In general, other sectors in the UK have taken a more prescriptive approach, generally to protect consumers and avoid incidence effects on consumer prices. This suggests that a similar approach might be appropriate here, but in most other sectors there was a single company.

7.1.1 Default tariffs in other sectors

Scottish water and sewerage arrangements

In Scotland, the regulator sets default tariffs at the maximum prices that customers would have paid to Scottish Water if competition was not introduced through default tariffs. This arrangement helps to ensure that no-one should be worse off from competition. It also limits the potential for incidence effects on customers' bills.

Electricity and gas arrangements in Great Britain

In the early stages of the electricity and gas markets, the regulators' approach to protecting customers was to retain maximum price caps until competition had developed sufficiently to permit their withdrawal. This meant that all new tariffs or changes to existing tariffs would be capped to the level they otherwise would have been subject to in the absence of the market. There was also an obligation set out in the legislation to offer published tariffs – irrespective of price caps set by the regulator. This applied to any customer using up to 10MW (that is, for those customers that were able to choose their supplier as soon as the market opened).

UK postal arrangements

In the recent review of the regulatory framework, Ofcom removed traditional price controls from postal products and, in place of this, implemented a safeguard cap on second class stamps. It also said that it would act as a 'backstop' for prices of first class stamps as an additional safeguard. Ofcom determined the safeguard cap by referring to:

- the level of affordable postal services for vulnerable customers;
- comparable prices across Europe; and
- the need for Royal Mail to have commercial freedom.

It determined a cap substantially above current prices.

UK telecommunications arrangements

On a number of occasions, Ofcom and its predecessor Oftel have applied 'safeguard' tariffs – for example in the fixed line retail market. They have based these safeguard tariffs on applying a price control of RPI-0% in place of an existing control.

7.1.2 Option 1

Under this option, we could set some **principles or requirements** for default tariffs. For example, we could require that default tariffs to cover the long run incremental cost of providing retail services. We could then ask companies to set their own default tariffs that met those requirements.

With this approach, we would not need to define the level of default tariffs, although we would probably still want to make ex post checks against our principles. While this is a risk-based approach and in line with our objectives for the contestable retail control, it may not provide sufficient protection for customers that are unwilling or unable to switch. This is because it would not be set consistently by the regulator.

There could also be implications for any supplier of last resort arrangements that may be needed in the market if retail entrants were to go into administration. In this example, having a variety of default tariffs in place across companies would raise questions about what tariffs customers would be on if their supplier went into administration. In particular, would there be an obligation for other retailers that inherited these customers to offer the default tariff of the outgoing supplier even though this was not consistent with their own offering?

If we were to adopt this approach, then we would need to put in place some principles for companies to follow when they set their default tariffs – taking our objectives for the retail control into account. For example, we could use the following principles for companies to follow.

- Default tariffs must at least cover companies' retail costs of providing the default level of service. This would be necessary to help competition to develop.
- Introducing default tariffs must not lead to unreasonable changes in customer bills, unless these are justified by changes to wholesale charges. This protects customers by minimising incidence effects, though it may be difficult to define 'unreasonable'.

Adopting this approach is likely to lead to a wide range of default tariffs, as companies may be able to set their own structures. We would rely on checking the default tariffs against our principles and using ex post regulation.

7.1.3 Option 2

We could be much more **prescriptive** and set tariffs and service levels directly. This could provide a higher degree of protection to customers, because we would be able to set tariffs that strike the right balance between efficient entry and protecting customers – although it might be difficult to get this right.

We could do this either by:

- setting a single set of gross retail margins permitted within default tariffs; or
- requiring companies to roll over their existing tariffs (and associated gross retail margins).

Adopting this option could be much more burdensome. And we would need to be careful that we do not set gross retail margins that are below retail costs.

Consultation questions

Q21 Do you think we should apply default tariffs using principles or through a highly prescriptive approach? Please explain your answer.

Q22 Are there alternative approaches we should consider? If so, what are they and why should we consider them?

7.2 Setting the default tariffs – a prescriptive approach

If we do as other regulators have done and adopt a more prescriptive approach – and then set gross retail margins for retailers to apply in their default tariffs – we think that there would be three ways of doing this. We set out each of the options below.

7.2.1 Option 1

With this option, we would set a **single default tariff structure**, with different gross retail margins for specific bands of consumption levels and meters sizes – based on differences in retail costs. This is a straightforward approach that would make it easier for both entrants and customers to understand the costs of providing retail services in the water and sewerage sectors.

But given the variety of charging arrangements currently in place, this approach could also create some incidence effects on customers' bills. These could be significant if all non-household customers were migrated to the default tariff.

7.2.2 Option 2

Under this option, we would set a **separate default tariff structure for each company**, with bands matching the tariff structures that companies have now.

This approach need not have any incidence effects, but it could be more complicated to set – particularly if entrants are required to offer default tariffs. We may need to strike a balance between simplicity for the market and the incidence effects that this will create.

7.2.3 Option 3

With this option, we could set **several optional default tariff structures**, to strike a balance between the advantages and disadvantages of the other two options. This could help if wholesale charges are structured differently in different regions.

In England and Wales, there is a wide variation in tariff structures that cannot be ignored. Among water and sewerage companies alone, there are more than 100 standard tariffs for non-household customers. The eligibility thresholds and structure of these tariffs are often different for each of the companies, depending on the approach they adopt. In the table below, we can see that across the ten water and sewerage companies, the volumetric charging bands are different. But three of the banding structures for those customers using less than 50 million litres of water a year would cover eight of these companies.

Table 5 Tariff bands offered by water and sewerage companies, <50 Ml

<table>
<tr><th>Volumetric rate</th><th>Number of customers (estimate)</th><th>ANH*</th><th>SVT</th><th>SRN</th><th>WSX</th><th>NES</th><th>TMS</th><th>WSH</th><th>SWT</th><th>NWT</th><th>YKY</th></tr>
<tr><td><5Ml</td><td>1,100,000</td><td rowspan="2">ü</td><td rowspan="2">ü</td><td>ü</td><td>ü</td><td rowspan="3">ü</td><td rowspan="3">ü</td><td rowspan="4">ü</td><td rowspan="4">ü</td><td rowspan="4">ü</td><td rowspan="4">ü</td></tr>
<tr><td>5-10 Ml</td><td>15,000</td><td rowspan="2">ü</td><td rowspan="2">ü</td></tr>
<tr><td>10-20 Ml</td><td>6,000</td><td>ü</td><td rowspan="2">ü</td></tr>
<tr><td>20-50 Ml</td><td>3,000</td><td>ü</td><td>ü</td><td>ü</td><td>ü</td><td>ü</td></tr>
</table>

* Anglian Water offers a range of Streamline tariffs for customers using less than 10Ml of water a year.

Many of these tariffs can be explained by differences in wholesale costs. But there may also be some differences in the costs to provide retail services to each group of customers. We could reflect this by setting more than one gross retail margin. Or we could vary the gross retail margin based on different bands of customer consumption or different meter sizes. We are currently running a charging project, which is considering wholesale charging issues.

In Scotland, the default tariff varies to reflect different bands of consumption. For example, based on the published directions (pp4-5), there are different default tariffs for customers that use less than 100 million litres of water a year, between 100 million and 250 million litres of water a year and more than 250 million litres of water a year. There are also differing fixed charges for different meter sizes.

To carry out this type of banding exercise, we would need to have a greater understanding of the costs of serving different types of customer. Companies already provide separate accounting information – and they are required to do so on a cost-reflective basis. One way of checking that companies' cost allocation is robust would be to carry out a full horizontal separation of their accounts and costs. But this could be unduly onerous and burdensome in setting default tariffs.

An alternative approach would be to develop an industry cost model that could be used either to set default tariffs or simply to check that default tariffs set by companies are cost reflective. Given the similarities between some elements of water retailing activities and retailing activities in other sectors, this could be developed using information from other sectors, which would reduce the burden on companies.

Consultation question

Q23 If we adopted a more prescriptive approach to applying the default tariff, how should the default tariff be set and structured? Please explain your answer.

7.3 Migrating onto default tariffs

In our future price limits consultation, we said that all customers would be moved onto the default tariffs at the next price review, and that all market participants would be required to offer default tariffs. But this may not be necessary as there are two approaches we could consider.

7.3.1 Option 1

We could simply require the companies to **offer default tariffs**, rather than requiring all customers to automatically move onto these. For example, this could involve a requirement for companies to present a reference price to these customers in their bills. This would mean that there are no incidence effects, as customers are not automatically moved from their current tariff.

Adopting this approach would also ensure that if there are no reasonable alternatives in the market for a customer that wants to switch, there is a default tariff that can provide the basic service levels at a reasonable price.

7.3.2 Option 2

An alternative option would be for us to require the companies to **migrate all customers** onto default tariffs. This approach would provide greater protection for customers, because they would receive the full benefit of the default tariff even if they did not wish to engage with the competitive market.

This option could result in more incidence effects if we set a single structure for default tariffs.

Consultation question

Q24 Should we require companies to migrate customers onto default tariffs, or just offer these as a reference price? Please provide evidence in support of your answer.

The protection that the default tariff offers may be a concern primarily for the smallest non-household customers. But, in general, we would still expect these, predominantly business and public sector customers, to need less regulatory protection than household customers.

In a market situation, participants will compete for the business of different customers. So, they are likely to focus on those customers from whom they can gain the most margin and profit. In the short term, it may be that larger customers are more profitable to competitive retailers – there is likely to be a period of rivalry where the prices offered to these customers are driven downwards towards cost. But over the longer term, competitive retailers will also try to switch smaller customers as margins become relatively more significant.

If we consider that larger customers were less likely to need the protection of a default tariff because they are much more likely to switch supplier, then we could choose to use other, softer ways of protecting them.

In general, these alternatives would offer a lower level of protection to larger customers. This could put them at greater risk of monopoly companies raising prices or dropping service levels in the period immediately after the market opens. But many of the largest customers are already on special tariff agreements and the absence of a default tariff may also allow the market arrangements to work more effectively for these customers. Without a default tariff market participants would be free to provide tariff and service offerings according to what these customers wanted without the signalling effects caused by the existence of the default tariff.

If we were to provide an alternative, softer form of protection for larger customers then we could consider the following options.

- We could require companies to have transparent charges and terms and conditions, notifying customers before changes in price/service levels are made. This would give competitors the information they need to compete more effectively with the incumbent supplier. It would also ensure that sufficient information exists for customers to make decisions about switching.

- We could require companies to set default tariffs for large users using the rules-based (rather than a prescriptive) approach we described previously. Since large customers are likely to be at less risk, we could apply a less prescriptive method – in line with our risk-based approach and similar to the way we currently control prices for large customers.

Consultation questions

Q25 Should the default tariff apply to all customers that have choice? Please explain your answer.

Q26 Are there alternatives to the default tariff that we should consider for larger customers? If so, what are they and how should they work?

7.4 Default service levels

A default tariff would also need to be accompanied by a default level of service. Respondents to our future price limits consultation were concerned about what these standards of service might be.

Companies are already subject to a series of regulated standards for non-household customers. These are scattered across the Water Industry Act 1991, secondary legislation, and the companies' conditions of appointment. But the primary source of service standards is the guaranteed standards scheme (GSS), which applies separately to household and non-household customers. These service standards are summarised in appendix 2, alongside a comparison with the default levels of service in Scotland.

From this comparison, it is clear that:

- in general, the regulated standards are straightforward and not particularly exhaustive;
- the standards apply to all non-household customers – there are no allowances made for different sizes or types of customers;
- the standards apply to all companies and regions equally (even though some companies offer enhanced levels of GSS payments);
- the standards are similar to those already offered as part of the default tariffs in Scotland, with one or two variations in the level of service required; and
- there are some other minor variations between Scotland and England and Wales in the service areas, which reflect the competitive arrangements in Scotland (some of which may need to be duplicated in England and Wales anyway).

We also know that the level of service provided on standard tariffs can differ from one company to another. For example, some companies offer their large non-household customers an account management service, while others do not. The regulated standards do not require these service levels.

There are two approaches we could take on service levels.

7.4.1 Option 1

Under this option, we could **use the existing regulated standards**. Companies already apply these minimum standards. So, this would be a straightforward way of developing default service standards. Also, the existing regulated standards are similar to the default service levels in Scotland. It ought to be possible to align the two sets of standards, which would support the UK Government's ambitions for a joint Scottish/English market. But it may not protect customers that already receive a higher level of service. Nor would it encourage as much retail innovation based on lower tariffs for lower standards of service for some commercial customers.

Also, using the existing regulated standards could encourage more competition for large users based on offering a higher quality of service. If this service was not included within default tariffs, there could be more scope for market participants to offer new tariffs with enhanced service levels.

7.4.2 Option 2

The second option would be for us to **develop new standards** that reflect the default tariff bands. This would require further work with companies to define these standards, and with customers to understand their willingness to pay for the service levels associated with the existing standards. It would also make the default tariff a much more onerous set of requirements, limiting the scope for tariff and service innovation beyond the service levels in the default tariff – with the potential of crowding out some of the benefits of a competitive market. But it may be more effective in protecting customers who are unable or unwilling to switch.

Overall, we can see real advantages to using the existing service levels. This would be a straightforward approach, in line with the regulated standards that customers already receive. It would also allow the market to operate more effectively without crowding out innovative customer offerings.

Consultation question

Q27 Do you support our proposed approach to set a default service level based on the existing service standards. If not, why not?

Appendix 1: Adjustments made by Ofwat at previous price reviews

A1.1 2009 price review (PR09)

- For the last price review, Anglian Water, South West Water, Cambridge Water, Folkestone & Dover Water (now Veolia Water Southeast), and Tendring Hundred (Veolia Water East) claimed that they had a higher meter penetration than the average. We accepted and made allowances for this.

- We allowed United Utilities, Northumbrian Water, South West Water, Thames Water and South Staffs Water adjustments for bad debt/deprivation.

- We allowed South West Water an adjustment to take account of the failure of the unit cost sewerage business activities model to allow for economies of scale

A1.2 2004 price review (PR04)

- Anglian Water, South West Water, Cambridge Water, Dee Valley Water, Folkestone & Dover Water (now Veolia Water Southeast), and Tendring Hundred Water (now Veolia Water East) claimed that they had a higher meter penetration than average. We accepted and allowed for this.

- We allowed United Utilities, Dŵr Cymru, Northumbrian Water, South West Water, Thames Water and South Staffs Water adjustments for bad debt/deprivation.

- We allowed South West Water an adjustment to take account of the failure of the unit cost sewerage business activities model to allow for economies of scale

- We allowed Dŵr Cymru an adjustment for additional customer service relating to its Welsh language obligations.

- We allowed Southern Water, Cambridge Water, Mid Kent Water (now part of South East Water), South East Water, Sutton & East Surrey Water, Three Valleys Water (now Veolia Water Central) and Thames Water an adjustment for regional salary costs, some of which may have been for employees engaged in retail services.

- We allowed Folkestone & Dover Water (now Veolia Water Southeast) an adjustment for industrial customers, which included an element of 'business activities' costs.

A1.3 Tariffs and charging

- We acknowledge explicitly that metered customers are more expensive to serve than unmetered customers in setting targets for the metered/unmetered differential.

- Our charging guidelines (published in November 2011) oblige companies to take account of these cost differences when setting tariffs.

Appendix 2: Summary of regulated service levels for non-household customers

A default tariff would need to be accompanied by a default level of service. Companies are already subject to a series of regulated standards for non-household customers. In this appendix, we summarise these service standards and also cross-references them with the ones included in the default tariff introduced in Scotland.

Service standards applicable to non-household customers	Summary description of standard applicable in England and Wales	Summary description of standard applicable in Scotland
Making appointments	If an appointment is made, the company made give notice to the customer that it will be either morning or afternoon; or if the customer requests it, within a specified two-hour time slot (GSS 6)	Licensed Providers (LPs) must ask customers if they prefer morning or afternoon appointment or a two-hour time band (DS 3)
Keeping appointments	The company must visit within the agreed time period or provide at least 24 hours' notice of cancelation (GSS 6)	The company must visit within the agreed time period or provide at least 24 hours' notice of cancelation (DS 3)
Low pressure	The company must maintain minimum pressure of 0.7 bar (GSS 10)	The company must maintain minimum pressure of 1 bar. If requested by a customer to investigate pressure concerns, the LP must arrange to do so and let the customers know the outcome within five working days (DS 9)
Notice of interruption to supply	Notification must be provided at least 48 hours before any planned interruption lasting more than 4 hours and stating when the supply will be restored (GSS 8)	Notification must be provided at least 48 hours before any planned interruption lasting more than 4 hours and stating when the supply will be restored (DS 4)
Unplanned interruption to supply (notifications)	Where there is an unplanned or emergency interruption to supply the company must take all reasonable steps to, among other things, notify the customer where alternative supplies can be obtained and the time when the	

	supply will be resumed (GSS 8)	
Restoration of supply	For planned interruptions, the supply must be restored by the time stated. For unplanned interruptions, the supply must be restored within 48 hours where this is the result of a leak or burst in a strategic main and within 12 hours for any other reason (GSS 9)	For planned interruptions, the supply must be restored by the time stated. For unplanned interruptions the supply must be restored within 48 hours where this is due to a leak or burst in a strategic main and within 12 hours due to a fault with the public water system (DS 4+5)
Account queries	For enquiries about the correctness of an account, the company must respond within ten working days. For requests to change payment method that the company does not accept, it must respond within five working days (GSS 7)	For enquiries about the correctness of an account, the company must respond within ten working days. For requests to change payment method the company must respond within five working days (DS 2)
Complaints	Companies must respond to written complaints within ten working days (GSS 7). Companies must maintain an approved and publicised complaints procedure (sections 86A and 116A of the Water Industry Act)	LP must try to resolve telephone enquiries during the call or by prompt return. LP's must respond to written complaints or requests for written responses to telephone complaints within eight working days (DS 1)
Internal sewer flooding	Companies must make a payment to customers for each incident of internal flooding equivalent to the customer's annual sewerage charge up to a maximum of £1,000 (GSS 11)	LP must refund the customer's annual wastewater charge for their property (up to a maximum of £1,000 per flooding event) provided that (i) the customer calls the relevant hotline; and (ii) the problem is not due to general surface flooding, a defect in the customer's private drains or as a result of the eligible customers actions (DS 7)
External sewer flooding	Companies must make a payment to customers for each incident of internal flooding equivalent to 50% of the customer's annual sewerage charge up to a maximum of £500 (GSS 12)	
Disconnection	Companies cannot disconnect	

	customers for non-payment of charges until seven days have passed from the notice issued to the customer requiring them to pay charges. If the customer disputes the charges, the company cannot disconnect them unless it has an enforceable judgment against the customers or the customer is breach of an agreement entered into in lieu of proceedings (section 61 of the Water Industry Act)	
Compensation for interruptions caused by drought	Where the customer's supply is interrupted under the authority of a drought order the company must, subject to some exemptions, compensate non-household customers £50 a day (condition Q of the companies' licences)	
Water getting into gas system		If customers experience this and notify their LP, the LP must refer this to Scottish Water and then, having received advice from Scottish Water, respond to the customer (DS 6)
Metering	Customers can ask for meters to be re-located and the company must respond with details of expenses if it agrees, or reasons why it does not agree. Customers can request a meter's accuracy to be tested. If it is functioning normally, the customer may be required to pay expenses. If the meter is registering incorrectly, the company must take account of this (Water Meter Regulations 1988)	LP must, on request, arrange for survey to establish if a meter can be fitted and then respond to the customer with an answer and, if relevant, the costs that are involved within ten working days (DS 8)
Response to emergencies		If Scottish Water declares an emergency, the LP must, among other things, notify its customers or, if requested by Scottish Water, ask customers to reduce demand (DS 10)
Telling customers about default charges		LP must communicate changes in maximum default tariffs within ten

		working days of those approval of those changes by WICS (DS 11)

Under both the GSS and Scotland Default Standards, any failure by a company to meet the standards will result in an obligation for the company to pay the customer a specified sum. In most cases, customers are not required to claim this and failure by the company to automatically provide the payment may result in further payments. The table below compares the payments required by the GSS and the Scottish default tariff.

Ref	Standard	England and Wales (GSS)	Scotland (default standards)	Late payment (GSS)	Late payment (DS)
GSS 7/ DS 1	Written or telephone complaints – written response within specified number of business days	£20	£20	£10	£20
GSS 7/ DS 2	Written account queries and requests to change payment arrangements – response within specific number of business days	£20	£20	£10	£20
GSS 6	Appointments not made properly	£20		£10	
GSS 6/ DS 3	Appointments not kept	£20	£20	£10	£20
GSS 8/ DS 4	Incorrect notice of planned interruptions	£50	£50	£50	£20
GSS 9/ DS 4&5	Supply not restored by agreed time or, for unplanned interruptions within 12 or 48 hours	£50	£50	£50	£20
DS 6	Water into gas mains		£20		£20
GSS 11/ DS 7	Internal sewer flooding	Annual sewerage charge (max £1,000)	Annual sewerage charge (max £1,000)	£50	£20
GSS 12	External sewer flooding	50% annual sewerage charge (max		£50	

		£500)			
DS 8	Meter installations	Yes	£20		£20
GSS 10/ DS 9	Water pressure complaints	£25	£20	-	£20
	Inform a customer of outcome of investigation within five working days.		£20		£20
DSS 10	Response to emergencies – meet emergency minimum standards of service	No – claim required	5%-15% of water or sewerage charge (max £5,000)		£20
DSS 11	Communicate changes to maximum default tariffs within ten working days of approval	Yes	£20		£20

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

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