

By email: charging@ofwat.gov.uk

1st November 2022

Dear Ofwat

Re: Consultation on charging innovation to support availability

Thank you for the opportunity to respond to this consultation. Charging innovation is one of the issues which we are currently considering, and have discussed recently with our Board.

Our responses to the consultation questions follow, please let us know if you would like to discuss any of these points further.

Yours Sincerely



Eleri Rees
Strategy & Regulation Director

Q1: Do you agree that companies should be looking at how they can introduce charging innovation to support affordability, as well as supporting environmental goals?

We agree that charging innovation can support affordability. We also recognise that charging innovation could be used to suppress demand for water, particularly in places or at times of the year when it is most scarce, and there are greater environmental benefits from reducing consumption.

The challenge in charges, and any amendments to charges policies, is in trying to achieve a balance between both objectives.

This diagram, adapted from a version in a paper published by the Organisation for Economic Co-operation and Development¹, identifies the trade-offs that are necessary in decision making:

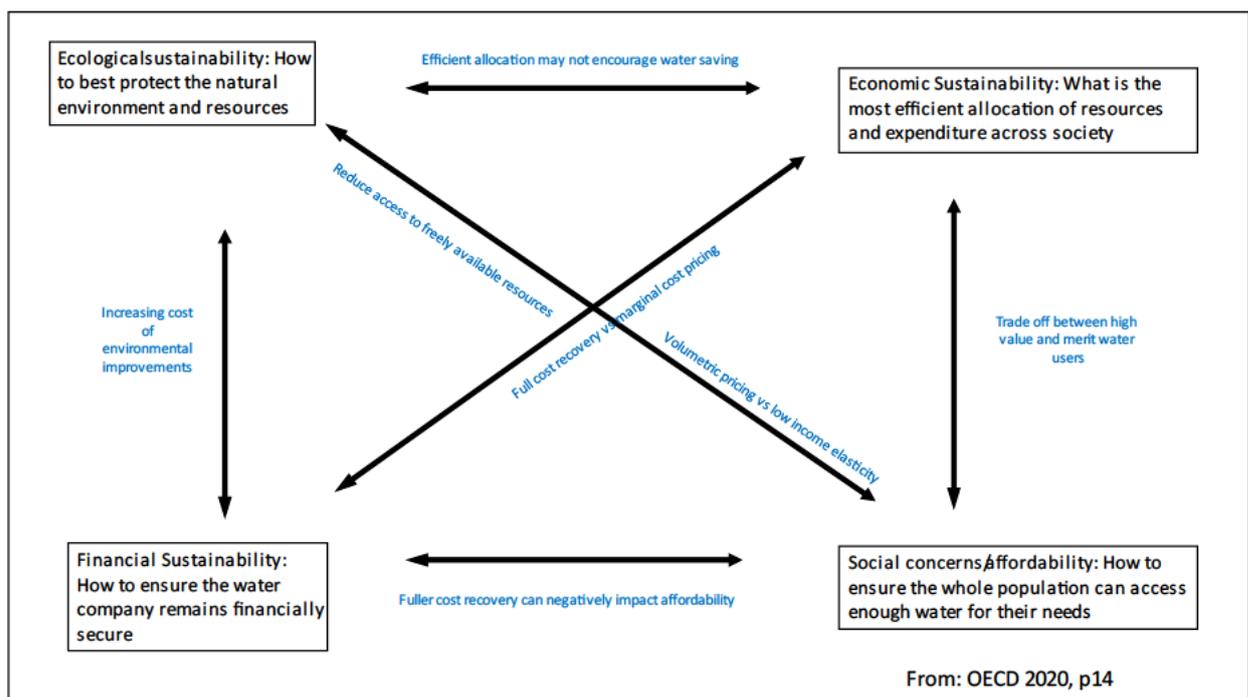


Figure 1 - Charges Policy Trade Offs

Ecological sustainability refers to the need to minimise water usage, to ensure efficient use of resources that we expect to become increasingly scarce. This largely implies tariffs designed to discourage consumption of water for what can be considered non-essential purposes.

¹ [Addressing the social consequences of tariffs for water supply and sanitation, Xavier Leflaive and Marit Hjort, June 2020](#)

Economic sustainability refers to decisions of resource allocation across society, in our case meaning across Wales. This involves considering the value of water as a resource, not just the cost of producing and distributing it.

Financial sustainability refers to the need for the company to cover its costs and remain financially resilient. This may be pressurised by the cost of acting in ecologically sustainable ways, and requires a balance of how much cost to put at volume risk through variable charges.

Social Concerns / Affordability refers to the need to keep water affordable, for all customers and particularly for those least able to pay. This is widely accepted, and the right to water is an element of "the right of everyone to an adequate standard of living for himself and his family" (Article 11 of the International Covenant on Economic, Social and Cultural Rights or ICESCR). The UK government considers that the right to water entitles everyone to a sufficient amount of reasonably affordable and accessible water necessary for survival, i.e. drinking, cooking and personal hygiene.²

This can conflict with aims to ensure economic, financial and ecological sustainability, all of which suggest charging at higher amounts than some customers may be able to pay. However, it could complement financial sustainability, by increasing the level of revenue collected and reducing the cost of non-payment of bills.

We recommend that Ofwat applies and promotes a similar framework in its consideration of charging policies. It is important to recognise that these objectives can be in tension with each other, and so prioritising one objective can come at the expense of another. For example, if we needed to place increasing weight on the need to reduce customers' water consumption, this might have an adverse impact on affordability, or conversely if we prioritise social wellbeing that may not provide the optimum financial, economic or ecological outcomes.

We attempt to find an equilibrium between these objectives in our charging policies, reflecting the company's wider strategic objectives and views of our stakeholders, regulators and customers. We should be aware of the role that tariffs can play in supporting other policy objectives.

Increasing the value of water would provide a price signal that would encourage customers to reduce consumption. But this may increase the bill for those customers who are unable to reduce their consumption and are also unable to afford the bill impact.

It is also questionable, at the current level, whether price signals achievable through water charges can be sufficient to encourage behavioural change. Water bills are currently, on average, less than one fifth of the capped energy price. This means they are less likely to be identified as a priority for budget reduction by households or businesses. However, the

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/36540/uk-position-human-right-water.pdf

current high level of all household costs may cause customers to look at all possible means of reducing bills, and the interaction between water bills and the cost of heating water may increase the focus here.

Q2: Do you have any comments on our regulatory framework for protecting customers, in the context of charging innovations?

With regards to Ofwat's proposed framework:

Insight – we agree that it is important that changes align to policies which customers are likely to support, and perhaps more importantly agree will have an impact either on their affordability or behaviour. We suggest behavioural studies may be useful in this regard, to observe actual impacts of potential changes, even prior to more formal implementation of trials. In designing studies, it should be considered whether prevailing economic or other concerns may be impacting results, meaning that they may need to be revisited in future.

Partnerships - We agree that a collaborative approach, including Ofwat, companies, CCW and other customer and stakeholder representatives will be beneficial to charging innovation. It is worth recognising that all parties are largely working to the same objectives on charging policy issues, as charges policy and innovation isn't a debate about the overall level of revenue, returns etc which is decided at price reviews (and subject to more conflicting positions), this is about apportionment and collection of that revenue in the optimum way to meet the objectives of affordability, customer protection, environmental improvement etc. As such, we welcome all attempts to improve collaboration.

C-MeX – we agree that this would to an extent capture any material issues with changes in policies. Although as customers respond to surveys and contact companies in relation to a wide variety of issues so it is not clear how visible the impact of charges innovations would be, particularly at a trial stage involving relatively small numbers of customers. We suggest that attaching regulatory financial incentives may not be the most appropriate means of encouraging innovation, as these may have a tendency to penalise failures more than they reward success. If we assume that the outcome of some innovations may be for some customers' bills to increase, then any dissatisfaction they experience could have a negative impact on C-MeX, which in turn may hamper innovation.

Reputational incentives – these are probably more effective incentives on charges innovation than C-MeX, as the reputational incentives are more likely to be driven independent expert views from Ofwat, CCW etc and can be compared across companies. These expert views can provide objective feedback, which can be supplemented by customer opinions. Reputational incentives are effective at a corporate level, Boards don't want to hear that their company is lagging, but they are less likely to impact customers' perceptions of their water company.

Revenue control – The Price Review framework recognises that affordability is a factor which has to be balanced against investment, expenditure and financing needs. This leads

to identifying an overall revenue level which is intended to be affordable to most customers, with additional protections in place for those least able to afford their bills.

Charging rules – We agree that the Charging Rules are important in ensuring fairness and balance in charge setting. As Ofwat has recognised, the rules did not ought to act as a constraint on charges innovation, and definitions of these concepts could be open to different interpretations.

Guidelines and company licences – We welcome the proposals in this area and are engaging through the industry group on development of the customer-focused licence condition. Our compliance statement on paying fair guidance is being produced for submission in December, and we welcome the additional protections to customers that these initiatives bring.

Social Tariffs

We note the ongoing work on single social tariffs at industry level, and we are continuing to prepare our plans for scenarios where these are and are not introduced.

Section 3 – Innovation in Charges

We found the analysis of alternative charging structures set out within section three of the consultation helpful.

We keep the options for implementation of alternative charges under regular review, and most recently presented these to our Board in July 2022, assessed against the principles we describe in response to question 5 below.

Our current position is that whilst we recognise the benefits that some alternative charging structures could bring to affordability or consumption reduction, these would largely be dependent on achieving a greater level of metering than our current 50% level. For such tariffs to be effective, customers would need to have information on their consumption and associated cost impact on a timely basis that allows them to alter their behaviour. Widespread smart metering would be required to facilitate this in addition to technological infrastructure to enable the flow of information to customers. Such technology has not yet been proven for use at a wide scale, and so it may be not be until AMP9 at the earliest that it can be implemented in a cost-effective manner.

We need to be clear that we should not necessarily expect water consumption to be linked to affordability. This is perhaps the case at certain times of the year, for example with better off families being more likely to fill paddling pools, water lawns etc. But generally, water consumption is linked to the number of occupiers of the property, in many cases there will be poorer households with larger families, who would therefore have unavoidably high consumption.

The consultation notes that reducing demand would improve affordability for most customers – we agree that this is true but shouldn't necessarily assume it is the customers most in need who would benefit most. It is possible that less wealthy customers may also be less likely to have water-efficient fittings, identify and repair leaks etc, as well as the link to family size.

We should consider what behaviours we are trying to amend or incentivise. Many customers may have limited discretion on the frequency or time of day when they can bathe, wash clothes etc. The natural inefficiency of garden watering during the hottest part of the day, for example, may help to manage demand through the day in hot periods without the need for further incentives.

There is also the question as to whether water charges could justifiably be set high enough to discourage usage – with water as a relatively small component of household budgets, compared to mortgages, energy bills, council tax, satellite tv etc, it may be that many customers would not be dissuaded from using more water when they want to unless the price of that additional consumption became prohibitively expensive. There is then even greater risk of creating affordability issues if the charging incentives are not correctly calculated and targeted.

As the consultation notes, levels of engagement may differ with the operation and impacts of these tariffs. This could adversely affect affordability, if for example elderly customers found the charges harder to understand.

Charges with rebates for reduced consumption

We think that there is potential for an interesting theoretical behavioural experiment of rebate versus up front charge reduction. But we would have concerns about whether the rebate is practical to calculate and apply. For example, whether it would take account of changes in consumption related to change in occupancy of the property. It would also need to be established how rebate payments would interact with Revenue Forecasting Incentives, whether these would act as retrospective adjustments to the previous year's revenues or deductions from the current year.

Sewerage Services

On page 21 of the consultation, it is suggested that lower water demand would reduce wastewater charges. We agree that would be the short-term impact of a reduction in consumption, but ultimately what matters is whether wastewater costs are reduced, and there is a real debate about that. Reduction in water consumption without any change in sewage load actually increases the strength of effluent whilst reducing dry weather flows. This could increase the costs of sewage treatment and sewerage network management, so in the medium-longer term it would not necessarily be the case that there would be a significant reduction in bill levels.

Surface Water Drainage

We are considering commencement of a trial to reduce SWD levels by creating greater incentives for customers to disconnect their surface water from the public sewer. This would be achieved through changing our charging basis from a flat rate per property to being based on the impermeable surface area of each property.

We intend to provide further details of our proposal once it is further developed and engage with Ofwat later in 22/23.

Q3: Do you have any comments on our proposed principles for good practice charging trials?

We agree that trials are often an appropriate means of testing and developing charging policy. Policy decisions to deliver specified objectives necessarily require a number of assumptions about customers' behaviour and reaction to incentives, these are not always predictable and may not identify other effects or consequences. It is easy to hypothesise about what impacts charges policies might have, but trials can demonstrate perhaps unexpected results and effects, which may mean that original policy goals aren't met.

Implementing new charges is also likely to incur significant cost, in terms of system change. It is best to be sure that these changes will be beneficial prior to commencing this change, and this will help to identify any system issues to be addressed.

Charging trials are likely to result in some incidence effects, causing some customers to pay more whilst others pay less, at least in the short term. Testing this at a lower level will help to identify the scale with this, and manage customer communication prior to wider roll out.

With regards to Ofwat's proposed principles:

Careful planning and design

Customer Engagement and Support – Ofwat proposes that “Charges need to be acceptable overall to the customers in the trial” – we question whether this is necessarily true, if they exhibit (or fail to exhibit) the behaviours that the trial is trying to incentivise. E.g. if a trial is intended to reduce consumption, but it doesn't and so the customers pay more, they might find the trial unacceptable, but it could be open to interpretation as to whether that means the trial has failed. We suggest a degree of discretion may be required in the assessment of this criterion, to consider whether the charges need to only be acceptable to those who have taken part in the trial, or the wider customer base.

Support for customers struggling to pay – consideration is needed on whether it is feasible to incorporate this in a trial without distorting the results, or to what extent it is preferable to exclude these customers from the trial. Trying to encourage water consumption through penalties may be counterproductive to affordability support, so we need to balance these objectives.

Whilst we support the view that trials should be very carefully designed, for them to be worthwhile it is almost inevitable that some customers would pay higher bills than they

would if they were not part of the trial. If a trial is designed so that everyone gets lower bills and it's just a question of by how much then there is a question mark over the validity and usefulness of the findings. Similarly, if people can choose not to participate it would seem that distortions are inevitable. This feature needs very careful planning and management. Ultimately, the weight of Ofwat and/or CCW in supporting trials could be essential.

Maximising Learning

Expertise, collaboration, sharing learning:

We agree that involving relevant experts will be helpful, for example in areas such as economic analysis and customer engagement. To some extent these costs are fixed, so applying at scale across multiple company areas could be cost effective and lead to a richer set of analysis. This supports the principle of collaboration.

We agree that companies working together would be beneficial, so it would be good to establish and formalise a means of doing so, whether through an Ofwat, CCW or Water-UK facilitated group/sub-group, or through a consultant-led project.

Sharing learning may be supported through collaboration and formalising the means of sharing, rather than industry participants waiting for studies to complete and companies to announce results, can earlier sharing and discussion be encouraged? Is there a role here for Ofwat in promoting/mandating sharing?

We should recognise that trials come at a cost, both financial and potentially through customer reaction, so it should be considered to what extent would companies want (or be expected) to take this on themselves and then share the results for free. This may be linked to the potential incentives explored in the consultation to encourage companies to lead on innovation.

The consultation suggests that sharing avoids repetition, but we should also recognise this may be helpful e.g. in different areas with different climatic conditions, economic circumstances, bill levels etc.

One particular suggestion we have is that, potentially through an information request, Ofwat collates and publishes the results of all previous tariff trials studies that have conducted since privatisation. This would allow others to review the results and consider whether similar studies are worthwhile repeating.

Q4: Do you have any comments on Ofwat's role in supporting good practice charging trials?

Our views are expressed within our comments on Q3 above.

Q5: Do you have any comments on the discussion regarding our charging rules and related regulatory compliance?

We welcome the proposed approach to the application of condition E, to allow for greater innovation in charges. We welcome the protection this will bring in the event that tariff trials prove unsuccessful or unpopular, as is the risk with trials of any sort.

We suggest that Ofwat may also need to allow a degree of flexibility in the event that effects of a tariff trial cause a company to breach the penalty thresholds of the revenue forecasting incentive mechanism – this might be unlikely in initial trials with smaller numbers of customers, but become more of a risk if successful trials are rolled out more widely.

Regarding the proposal that charges should reflect:

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

We think these principles align to our own charging principles. We have developed our own assessment framework for assessing the impact of charges policies against a number of criteria The DCWW Board considered options for charges reform and innovation at its July 2022 meeting and agreed a set of criteria against which charges policies should be assessed.

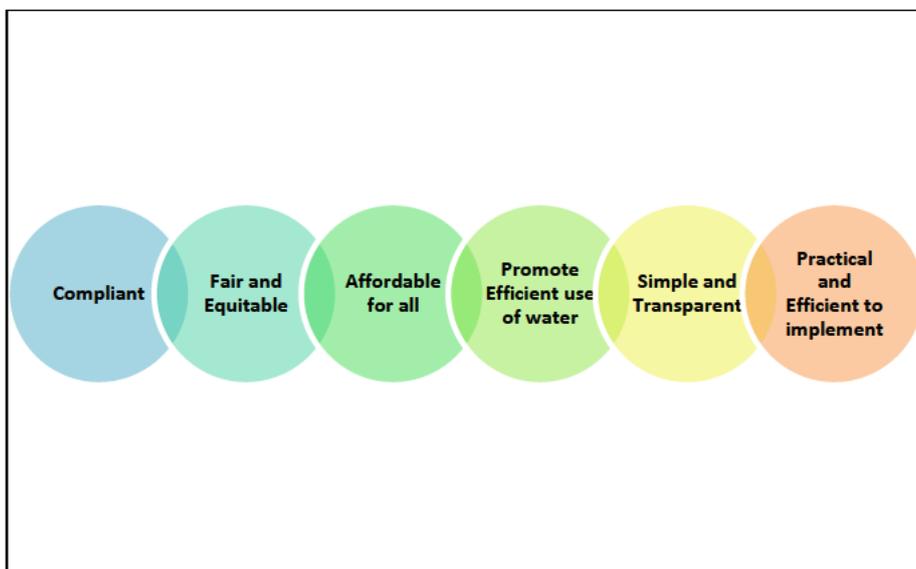


Figure 2 - Dŵr Cymru Charging Policy Principles

We describe these principles as follows:

Compliant

Dŵr Cymru Welsh Water should continue to provide a charging structure which is **compliant** with the company’s licence, the Water Industry Act, Ofwat’s charging rules, UK

competition law and any other relevant UK or Welsh government guidance and legislation. This is a non-negotiable aspect of our charges policy, as failure to achieve this could lead to enforcement action from the regulator or government. We apply a strong governance and assurance framework to our charge setting calculations and policy decisions to ensure that they comply with all relevant requirements.

Fair and Equitable

Charges should be set in a manner which is considered **fair and equitable** across the whole customer base, taking into account customers' usage of water and their ability to pay for it, and the company's costs of providing services, as a whole and to individual customers.

This is a complex trade-off, as the concept of fairness could be interpreted in different ways with respect to water charging. It could be considered fair that all customers pay the same amount, or it could be considered fair that customers pay precisely in relation to the amount of water they use and the cost of providing it to them.

In practice we must find a balance between allocating costs in accordance with the cost to serve different customers, with assigning a degree of cross-subsidisation to ensure that the costs do not fall too heavily on customers who may be unable to afford it. Through this principle we seek to ensure that customers are able to afford their basic water and wastewater needs.

Affordable for all

Charges should be **affordable for all** of our customers. Affordability is primarily a function of the overall level of bills rather than charging structures, and we have a separate system of social tariffs in place to support customers who are unable to afford their bills. This principle also seeks to recognise the impact that any changes in charges policies could have on wider groups of customers which may cause their bills to increase significantly from the current levels.

Promote Efficient Use of Water

Charges should encourage customers to be **efficient in their use of water** and wastewater services, so as to

- reduce the amount of water that the company needs to abstract
- reduce the amount of carbon that the company needs to use in its operations; and
- support the company's resilience against any potential droughts or water shortages

This principle requires us to find a balance between encouraging customers to use less water and not setting charges in a way which would unduly penalise those customers who have a genuine need to use greater amounts of water.

Practical and Efficient to Implement

Charges should be set in a way that is **practical and efficient to implement**, taking into account the costs and other practical considerations associated with obtaining and holding necessary data.

We recognise that to set charges in a way that targets the above objectives most precisely would require us to hold significant amounts of data on our customers. In practice, it is not practical, or cost efficient, for us to obtain this data, and in some cases we would be legally prevented by GDPR from doing so. This then limits our ability to take into account factors about the property or its occupants which are not known to us when setting tariffs.

Simple and Transparent

Charges should be as **simple and transparent** to customers as possible. It is important that customers understand what they are being charged, and how that charge is calculated. Failure to achieve this can lead to customer dissatisfaction, which may adversely impact metrics such as C-MeX, and also customers' propensity to pay their bills, which may impact our bad debt rate. Whilst the calculations that sit behind charges may be complex, these should be translated into a framework that can be easily presented and understood. This includes the impacts of making changes to any charges policies, both in terms of the practical steps required for implementation, and the likely reaction from customers and stakeholders with associated requirement for handling strategies.

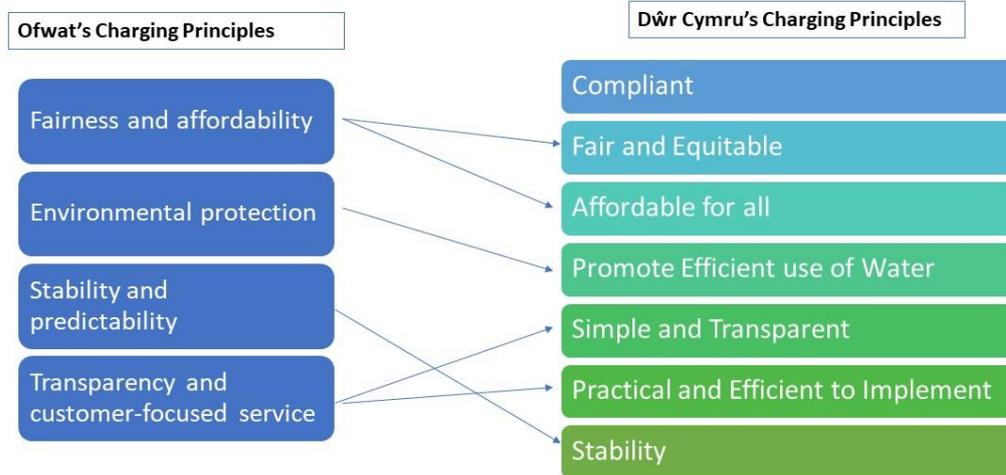
Secondary principle - Stability

In addition to these primary principles, the company places considerable weight on the **stability** of prices. For most customers water and wastewater are essential services, and unexpected sharp swings in price – upwards or downwards – are considered detrimental due to the impact on managing household budgets.

However, it is important to be clear that this is a principle that applies to the *path* of prices, i.e. the rate at which they change from one time period to another, not their long term level or structure. Stability is not a relevant consideration for the determination of what prices or policies should ultimately be” in other words, the company does not consider that keeping tariffs the same as what they were last year, with no other underlying justification, is a valid principle for setting charges.

We included compliance as a principle, but that is implicit within the application of Ofwat's charging rules and guidance and so agree it would be inappropriate for Ofwat to include.

Mapping Ofwat Charging Principles to DCWW's



In defining our own principles and reviewing Ofwat's, we recognise that these are somewhat subjective assessments and can be open to interpretation.

We don't suggest that further guidance or amendment to the definition is needed, it can be left to companies and their Boards to explain how they have interpreted and applied these principles in their own policies. In early application of this amendment to the charging rules there may then be a need for some engagement between companies and Ofwat to ensure definitions are being applied in a consistent and appropriate way.

Regarding the proposed clarification of the charging rule "*Consistent principles and approaches must be applied to the calculation of charges for different classes of customers*" in the context of tariff trials, Ofwat may need to provide a more specific definition of what constitutes a trial; for example whether there is a limit to the proportion of a company's customers it can apply to, or a limit to the duration on which it can be considered a trial.

Alternatively, Ofwat could consider dispensing with this rule entirely, as its objective should be covered by the introduction of the new charges principles. If a charge can be said to be fair, stable, predictable and transparent, then these criteria could be said to supersede any requirement for consistency. This may also support better targeting of tariffs beyond trial periods.

Other Charging Rules

As part of this review, we suggest Ofwat may wish to consider whether the definition of the requirement for provision of the impact assessments and handling strategies developed in instances where bill increases for particular customer types exceed 5%. The customer

protection this rule provides is now supplemented by the principles around fairness and affordability, and stability and predictability, so it is worth re-assessing what purpose this rule should serve.

Whilst this rule has operated as a relatively consistent threshold during a period of consistently low inflation, as we move into a period of greater fluctuation we suggest setting a threshold relative to the level of inflation may be more appropriate, i.e. for any bill increases greater than 3% above inflation. This would enable earlier and firmer engagement, which can be focused on those tariff changes which are due to reasons other than inflation, and not be dependent on forecasting inflation effects. We do however recognise that inflation itself creates a significant impact on customers' bills, and companies should engage more widely with their customers around the overall level of bill changes.

We agree that specific handling and engagement strategies will be needed for all trials, regardless of the level of bill impact.