Consultation on charging innovation to support affordability

Severn Trent Water response

November 2022

WONDERFUL ON TAP

SEVERN TRENT

Consultation on charging innovation to support affordability

Overview of response

We consider that this consultation is timely, and agree that new methods of charging should be considered as a tool to address some of the challenges that the industry faces. Climate change and population growth create significant pressures on water supply and the management of surface water. Large-scale investment to address these raises affordability concerns and an innovative charging strategy could play a role in addressing these challenges.

There is scope for wastewater charges to send positive price signals around sustainable drainage. These could be important in terms of our long-term plans for the drainage network. We will be responding to your consultation by trialling a discount scheme for Sustainable Urban Drainage Schemes (SUDS); this will support our Green Recovery programme in Mansfield. The scheme will give customers a reduction in their surface water drainage charges for SUDS that attenuate flows into our sewerage network. We look forward to meeting with Ofwat to discuss our proposal further, building on the approach in Ofwat's consultation.

In our responses to Ofwat's questions we are supportive of innovation in charging but mention a number of factors that the sector will need to take into account. For example, key enablers for many of the innovative charges are more sophisticated retail systems and meters, which require investment. Some of the expenditure will be in the retail price control which has limited scope for investment because of different cost-sharing arrangements and a non-indexing control. We agree that some types of charge - such as Rising Block Tariffs (RBTs) - could reduce consumption and have positive redistribution effects. However, this will only be true if the tariff takes account of the number of people in each household, so that large families are not penalised – this will require companies to be able to collect information on household size.

Tariff changes will have an effect on other aspects of the regulatory regime. If they have redistributional effects they will create "losers" as well as "winners", and there could be a greater propensity for the first group to contact their water companies. In addition, innovative tariffs such as RBTs could make revenue more volatile. If they are rolled out more widely, Ofwat should consider whether there are other aspects of the regulatory regime that need to be modified in order to encourage tariff innovation - for example, the interaction with the Revenue Forecasting Incentive (RFI).

We support the principles of good practice for tariff trials, which are particularly relevant for wide-ranging changes such as RBTs; these would affect a large number of residential customers from a range of socio-economic backgrounds. We think that the approach needs to be proportionate to the scale of the trial – for example, if a trial affects a limited number of non-households then the approach should be tailored accordingly.

It is encouraging to see that Ofwat is prepared to support charging innovation through its communications, and we think this will be important in providing customers with the confidence that companies are not seeking to profit from the trials. We support the proposed changes to the Charging Rules, and do not believe a further change to Condition E is necessary in order to facilitate the introduction of tariff trials.

We are happy to discuss this response further and look forward to bringing forward proposals in the near future.

Consultation questions

1. 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 strongly support many of the ideas raised in this consultation and are actively looking at the ways that we might use charging to support our longer-term strategy. Considering the problems posed by climate change and water scarcity – and the pressure these could put on customer bills - we need to consider all available tools to address these challenges.

Demand-side measures such as tariffs could help in two ways. Firstly, if they are effective in reducing discretionary water consumption, they would lower the need for new investment. Secondly, if well-designed, they could improve the affordability of water services by providing a volume of water for essential use – a "lifeline block" at a reduced rate.

The consultation suggests that Rising Block Tariffs (RBTs) and Time-Of-Use (ToU) charges could have both environmental and redistributive benefits. We agree – but only if:

(i) The marginal cost of water for discretionary use can be set at a meaningful level (sufficient to incentivise reduced consumption) and customers are aware of the high marginal cost; and

(ii) The "lifeline block" can be set on a per capita basis, so that the tariff discourages *discretionary use* (such as watering gardens and washing cars) rather than simply targeting *high use* (such as large families who might have relatively modest incomes).

RBTs are used in many countries, but academic reviews of these tariffs (such as the Boland and Whittington[1] study referenced in the consultation) found that these did not have a large impact on water consumption. This could simply be due to the marginal cost being too low to send a strong enough price signal. There can be a problem if the marginal cost of water is quite low – particularly relative to the income of more affluent customers that are likely to have discretionary use at peak times. If these customers are more aware of the unit rate, they may simply make the conscious decision that the marginal benefit of (say) watering their garden is worth that unit price. Setting a unit price that is sufficiently high to affect usage could end up in a company significantly over-recovering against its revenue allowance.

Boland and Whittington's study also found that RBTs did not improve affordability. In our view, this is because of the second issue – the "lifeline block" was set without regard to the number of occupants in a household. The independent Walker Review reached the same conclusion – without a robust way of establishing occupancy, RBTs would not be fair.

Charging or taxation systems based on occupancy are fraught with difficulty, as the Government discovered when attempting to implement a "poll tax" in the late 1980s. For water companies to collect this information from residential customers would be difficult. We do not have the data-gathering powers

[1] Boland, John & Whittington, Dale (1997) – Water tariff design in developing countries: disadvantages of increasing block tariffs (IBTs) and advantages of uniform price with rebate (UPR) designs

of Government (which were – as noted – not sufficient for the purpose). If we asked customers to provide this information by offering the incentive of more cheap water – i.e. "lifeline blocks" set on a per capita basis – then we would need to verify the number of residents and monitor this on a regular basis. If the information was not accurate it could raise GDPR concerns and the administrative cost might well outweigh the benefits.

We think these issues might be overcome with the use of technology – i.e. using smart meters to infer the level of occupancy by monitoring off-peak usage. This is something we intend to explore going forwards. But it will require investment in meters and in billing systems that are capable of deploying such tariffs – particularly more sophisticated ToU charges that seek to apply premium rates based on narrow periods of time.

Much of the focus in the paper is on incentives for water usage, as this is where the redistributive effects of RBTs or ToU tariffs could come into play. But the industry also faces a key environmental challenge from more intense rainfall, and there is scope for charging to play a part in addressing this. Severn Trent was the first company to apply a site-area approach to surface water drainage (SWD) charges, which is the best available driver for SWD cost. This can provide an incentive for customers to reduce the volume of rainfall that drains to the sewer, because they can take action to reduce the "chargeable area". To support our Green Recovery programme in Mansfield, we intend to trial a discount scheme for Sustainable Urban Drainage Schemes (SUDS) that attenuate surface flows. Such discounts have been applied to non-households by a couple of companies within the industry and we will be looking at whether we can extend the approach to residential customers.

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

There are many protections in place for customers – for example, the revenue cap means that companies cannot increase their revenue through changes in charging policy. However, Wessex Water's experience of testing RBTs and seasonal tariffs suggests that some customers may distrust the company's motives, even if this is explained to them. This could have an impact on C-MeX scores, depending on the extent to which such tariffs are rolled out.

While the consultation notes high levels of satisfaction with the examples of innovative tariffs in the energy sector, this was amongst customers that had selected those tariffs and stood to benefit from them. Considering the example of RBTs, if we wanted to see these delivering redistributional effects then there would need to be "losers" as well as "winners".

With more complex tariffs there will be more scope for error, and this also points to the need for investment in better systems. But at least some of this would be retail investment which has been heavily constrained in recent years by having a non-indexing price control and no cost-sharing – this would be an increasing problem if we are entering a period of higher inflation.

The revenue cap does mean that a discount for one set of customers will lead to an increase for any customers that do not receive it. When companies create any new tariff, they need to strike a balance between the interests of the customers receiving a positive incentive and the incidence effects for other customer groups.

In addition, charges that apply premium rates to any block of consumption may lead to greater revenue volatility. For example, during hot weather we might see an increase in consumption at higher marginal rates; this would be a problem if charges had been set significantly above cost for those upper blocks. It

would be perverse if a company that was trying to deploy innovative tariffs suffered a penalty because its revenue fell outside the 2% deadband under the Revenue Forecasting Incentive (RFI). Ofwat might need to consider how the excess revenue could be recycled back to customers without a penalty, because companies would not be trying to profit through this charging strategy, only to manage demand in a responsible way.

Considering the Charging Rules and Condition E, a further issue with RBTs is ensuring equitable treatment of non-households. If we do manage to set a per capita based "lifeline block" then there is a question about how this could operate for properties with no occupants. However, before that the industry would need to address the falling block tariffs (FBTs) that are currently in widespread use for larger non-household customers; it would be incongruous to have both RBTs and FBTs at the same time.

We also need to consider the implications for retailers. Through the Retailer Wholesaler Group there is a drive for wholesale charging structures to be made simpler and more homogenous. Many companies have tried seasonal tariffs for non-households and have subsequently dropped them. Severn Trent was one of a few companies that still had a seasonal structure at market opening. We have now removed them – not just because they were complex, but also because they were not effective in changing non-household behaviour. The seasonal usage patterns of business customers were generally driven by the nature of the industry and the degree of discretion over that usage was low. As such, the tariff increased or reduced charges based on what customers were already doing rather than driving change. We think seasonal approaches might work better with residential customers where summer use is more discretionary, but note the need to avoid undue preference between customer groups.

3. Do you have any comments on our proposed principles for good practice charging trials?

The proposed principles for good practice are sensible, particularly for trials that are likely to impact on a wide range of customers with a range of circumstances. For example, we think the principles around customer engagement, support for customers that struggle and communication are highly relevant to RBTs or ToU charges that might be applied to a wide section of the residential customer base.

We would add the principle of proportionality. Where the tariffs being trialled would not apply to a large number of customers, it might not be appropriate to require that a company fulfil all of these principles as if this was a "tick-box" exercise. For example, when evaluating the trial the consultation envisages that a range of different alternatives might be tested against each other. With smaller-scale trials it might be reasonable to consider the experience of companies that have deployed similar tariffs and select or adapt those which appear to best meet charging principles.

This would be a particular issue with trials that are primarily aimed at larger non-households or new developments. For example, our response to Q1 discussed a potential trial of a SUDS discount in the Mansfield area. It will only be practical to retrofit SUDS on a small number of properties or implement on new build properties. As such, we might have too small a pool to trial a range of alternatives and it might be better to focus on a robust evaluation and refinement of a single option.

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

Communication will be the key benefit, in our view. When Wessex Water conducted tariff trials before, some customers were incorrectly suspicious that the company was using the new tariffs to drive higher

profit. If Ofwat can provide confidence that this is not the case, then this will help us manage interactions with our customers. The suggestion that Ofwat could provide support in sharing information is also sensible.

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

We are comfortable that the proposed change in the Charging Rules is sufficient to clarify that tariff trials can be conducted. We do not believe that it would be necessary to amend Condition E of the Licence in order to allow for this. Companies conducted tariff trials before the introduction of Charging Rules and this was not held to be “undue preference” under Condition E.