



Emily Bulman
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Peter Trafford
Head of Regulatory &
Market Economics

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Dear Emily,

[Consultations on Charging Innovation to Support Affordability and Changes to the Charges Scheme Rules from April 2023](#)

Thames Water welcomes the opportunity to respond to the consultation on Charging Innovation to Support Affordability and the statutory consultation on changes to the Charges Schemes Rules from 2023.

We support the amendment to change the Charging Scheme Rules. The ability to conduct new tariff trials is important in making the case for any substantive change to tariffs and so we support the addition to rule 12, which is both clear and unambiguous. One area where further guidance could be helpful is over interpretation of “an appropriate limited period”, as some trials, e.g. seasonal winter/ summer tariffs could potentially require several years to obtain robust results.

We fully support the objectives of the consultation on Charging Innovation to Support Affordability to help our most vulnerable customers especially during the current cost-of-living crisis.

Understanding our customers’ water consumption and its uses will have a significant bearing on tariff design. Making a distinction between discretionary and non-discretionary usage will be important. For discretionary water usage, there is scope for innovative tariffs with the potential for a significant reduction in consumption and more progressive charges. However, we note that on some occasions the price signal may not always work for water intensive activities, such as gardening, swimming pools or hot tubs where the value of the activity is high to the customer relative to the cost of water. There are also cases of low consumption users that are second homeowners who may enjoy lower overall charges than they might otherwise have if a block tariff is introduced, through effectively splitting consumption across two meters.

There are some known limitations of implementing the alternative charging structures summarised in table 2 (page 14) of the consultation. The majority relate to the ability of the methodologies to use consumption and water usage data. We provide some thoughts on these in Annex 1.

We agree with proposals outlined in chapter 4 of the consultation regarding good practice for developing charging trials. We have identified the importance of understanding consumption and usage with the need to be aligned with ability to pay, so we can develop robust and enduring charging structures. This is likely to be crucial particularly for options such as rising block tariffs, premium and time of use charges that are sensitive to consumer consumption. However, it may not be easy to develop new charging structures without some knowledge of our customers' circumstances, which will be a research challenge.

It is important in the evaluative phase of the research to identify the impact on different consumer groups of new charging structures. We would therefore add to the list in Box 1 on page 25, the importance of fully understanding the redistributive impacts of any new charging arrangements.

We have included answers to the consultation questions in Annex 2. We welcome further discussion on the guidance. If you have any queries on the response, please do not hesitate to contact me, [REDACTED]

Yours sincerely

A rectangular area containing a blacked-out signature, likely of Peter Trafford.

Peter Trafford
Head of Regulatory & Market Economics

ANNEX 1

Charging Structures Compared

| Charging structures | Ofwat comment | Impact on Affordability | Impact on Environment | Challenges and opportunities |
|------------------------------|--|-------------------------|-----------------------|--|
| Rising block tariffs | Well-designed RBTs reflect a balance between essential and discretionary use. They can result in lower bills for customers with essential use and incentivise reduction in discretionary use | Y | Y | The 2011 Walker Review concluded that “difficulties of ensuring that in practice the outcome is fair are significant.” In particular, the establishment of occupancy. May not help for poor large households with inelastic demand. It only works if the tariffs can capture discretionary consumption. |
| Premium charges | Different charges applied under pre-defined criteria could provide a more cost reflective recovery of costs and could incentivise reduction in demand in challenging supply conditions. | X | Y | Will only work if effectively targeted, ideally to “super users” only. If this is done it will still have a redistributive effect. Does not necessarily need to cover costs, just act as a deterrent Could harm those poorer customers who are large consumers of water unless they can be identified |
| Time-of-use charges | Charges that reflect different patterns of use (e.g. seasonal variations) could incentivise reduction in usage in peak periods and/or recover a greater proportion of revenue from customers using more water in those periods | Y | Y | Can be effective at changing discretionary behaviour, with notable precedents in energy. Is limited by the fact that water supply is an essential service and therefore demand cannot be easily moved between periods in contrast to other types of consumption. The information needed to implement ToU charges, and its accompanying infrastructure is expensive and may not work for those customers with inelastic demand. |
| Two-part charges with rebate | Such charges provide a discount to reward certain behaviours, such as reduction in household water usage. | X | Y | Requires knowledge of occupancy. May be feasible to link some customers via the Priority Services Register. It has the bonus of being linked to saving water. |

ANNEX 2 – Consultation questions

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?

Yes, we welcome the opportunity to explore how charging rules can be evolved to make our services more affordable and create better environmental outcomes.

Fairness is an important concept in tariff design and is based different perspectives, and we set out in the table below some comments on concepts of fairness.

Concepts of fairness in the economics of tariff/ rates development

| Concept of fairness | Description | Commentary | Economist |
|--|--|--|---------------------|
| Tariffs should reflect those with a high willingness to pay over those that are not willing to pay more. | Ramsey pricing: based on the inverse of the elasticities of demand for a good. In this model Water Companies differentiate between customer groups and charge accordingly. | Difficulty in identifying customer groups. Difficulty in calculating charge once identified. | Frank Ramsey |
| Rates are only fair if any increase in production level will be exactly matched by a corresponding increase in sales. | Optimal general welfare is prices for goods set at marginal cost. Water companies instead price based on consumption. | Assumption that marginal costs are substantial enough to create an incentive for customer action. | Harold Hotelling |
| Rates are only fair if they only reflect those costs that tend to change with a decision, ignoring others that are fixed. | Utilities should charge only at incremental cost (the “10 cent” train ride). In this example, a train is about to leave the station but there is one free seat. The cost of the few grams of coal for the extra weight of passenger and wear and tear on the track will be 10 cents. | Assumption that incremental costs create any real incentives or even substantive differentiation | Robert H Montgomery |
| “Peak load pricing.” Charges must cover the peak load and give a signal to customers to moderate their usage. This is achieved by a peak/ off peak tariff. | Peak load pricing: The concept of tariff implies a permanent revenue flow in order to balance the flow of demand and flow of production. The marginal/ incremental concepts mentioned above are contradictory with each other. His solution is to split charges into peak and off peak | Easy to implement with robust metering in place. Even if this is not the case it is still possible to develop accurate tariffs. The key drawback is sufficient understanding of costs. | Marcel Boiteux |

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

We are comfortable with the framework for protecting customers.

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

We agree with the principles stated on page 23 of the consultation. If there is a redistributive element it will be important to have a discussion on the implications of the findings.

We note that behavioural/ experimental economics that might be deployed has its critics, and we will work to address the concerns in any trials. Some small nudges that might, for example, be

associated with charging structure design, may not be effective substitutes for mass intervention. Discoveries about the past from behavioural experiments or trials do not always easily generalise for future customers. This could be due to a dynamic social context for example, changing perceptions linked to fear of drought, climate change or the affordability crisis. We also know that information from random control trials has no special status in the absence of other “helping factors” such as societal beliefs or background knowledge that aid policy deployment.

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

We agree with the need for and appreciate the offer of Ofwat supporting water companies in implementing good practice charging trials.

The production of a web page confirming the aims of such trials and providing a suitable FAQ section would be of great use, especially to de-bunk the myth that companies are trying to maximise revenue. Going a step further, if water companies were able to include in pre-trial engagement communications with customers an insert or letter from Ofwat (specific to the company rather than to the trial for the sake of practicality) setting out the legitimacy of the upcoming trial and sign-posting customers to the web page, it may provide an even greater level of comfort to the customer.

Regarding the sharing of learning, we wholly agree that the findings from charging trials should be shared as fully as possible. We don't necessarily see why such an exercise would need to be routed through Ofwat. Subject to commercial sensitivities, water companies should be able to share findings directly with each other in the spirit of collaboration and in the absence of any obvious competition obligations or restrictions when it comes to household charging trials.

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

As Ofwat allude to in section 5.2.2 of the main consultation document, the charging principles that are being proposed have, historically, always been considered due to their appearance in the wholesale charging rules. We therefore agree with and support the formal inclusion of these charging principles in the Charges Scheme Rules.

We also support and appreciate the clarification that the proposed change to current rule 12 will bring regarding being able to apply different charges to similar customer groups for the purposes of a charging trial.

We appreciate the acknowledgement that the balancing of principles and objectives is a key part of the way in which water companies can and are expected to use the charging rules. A degree of freedom in interpreting and applying the rules is vital to ensure that charging structures and subsequent pricing levels are set in the best interests of customers, companies and the environment.

We note that in section 5.6 of the consultation document, it mentions the expectation that trials will commence at the start of and run for a full charging year. Whilst we fully appreciate the need for stability and predictability for the customer, and sufficient time and data for the company to effectively assess the merits of the trialled charging structure, it should be recognised that not all trials would necessarily need to start at the beginning of the charging year to achieve their objectives. Clarity on whether it would be mandatory to wait until the beginning of the next charging year would be very useful.