

# Consultation on wholesale charging rules

Severn Trent Water response

9 September 2016

## Summary of our response

We welcome the opportunity to provide feedback on Ofwat's draft charging rules for 2016/17. In general we are supportive of the draft charge scheme rules. Although early publication requirements represent an additional burden on companies, we think that Ofwat has struck a reasonable balance between providing retailers with the information they need to plan their pricing strategy and placing excessive constraints on wholesalers. The only aspect of the proposals which continues to give rise to significant concerns is the drive to publish separate charges for highway drainage.

We think that the revealing information to customers through the form of charges can create powerful incentives. This is why we already publish separate charges for foul water, trade effluent and surface water drainage. Customers can influence these charges – for example, by reducing the volume of waste water they discharge. But publishing highway drainage charges will not help wholesalers or retailers to control costs, because the cost is not caused by customers.

Highway drainage costs are driven by the investment decisions of agencies that do not pay sewerage bills<sup>1</sup>. The structure of sewerage charges cannot influence their behaviour. In effect, this is a tax in kind. Given that all customers will use the road network – and the level of use is not connected to their water consumption or property – it is not clear how this tax can be levied fairly. Customers not connected to the sewer system cannot be charged for highway drainage, but still make use of the roads. Arguably, if there is no link to a customer's surface area or consumption then a flat rate or "poll tax" approach might be adopted. But doing this would mean proportionally higher increases for small customers. And whatever method is used, customers are likely to question the basis for the new charge.

The consultation proposes to introduce a rule two years before it is due to go into effect. We think this is premature. The consultation suggests that companies should engage stakeholders on their approach to implementation; in our view, Ofwat has not made the case for the benefits of separation and should engage with stakeholders to gauge the demand this measure before deciding on the rule. Our discussions with CCWater to date have indicated a shared concern that the publication of highway drainage charges will drive an increase in customer contact without delivering any benefit.

If the aim is to provide information on highway drainage costs to retailers, we would suggest that there are other ways of doing so. If the aim is to encourage more sustainable drainage arrangements, then the information should be directed towards those that give rise to the costs (i.e. local governments and the Highways Agency).

If you would like to discuss anything in this response further, please do not hesitate to contact myself or a member of my team.

Dr Tony Ballance  
Director of Strategy and Regulation  
Severn Trent Water

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<sup>1</sup> Section 146 (4) of the Water Industry Act prevents sewerage undertakers from charging a highway authority for the costs associated with draining roads and other common areas

Contacts:

Dr Tony Ballance	Director of Strategy and Regulation	<a href="mailto:Tony.Ballance@severntrent.co.uk">Tony.Ballance@severntrent.co.uk</a>
Shane Anderson	Head of Economic Regulation	<a href="mailto:Shane.Anderson@severntrent.co.uk">Shane.Anderson@severntrent.co.uk</a>
Jim McLaughlin	Tariffs Manager	<a href="mailto:James.Mclaughlin@severntrent.co.uk">James.Mclaughlin@severntrent.co.uk</a>

## Response to consultation questions

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

As noted in our overview, we are not convinced that the separation of highway drainage charges can deliver any benefit for customers and is likely to drive an increase in unwanted contact. In addition, there appears no need to introduce a charging rule for 2017/18 that will not take effect until 2020/21. Given that question 6 envisages stakeholder engagement on the topic, it appears premature to introduce Rule 20 in advance of that consultation.

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

We think that a 5% threshold is reasonable given the current low levels of inflation, but this needs to be kept under review. It will be impractical if we return to the levels of inflation seen in the past. For example, in 2011-2013 November RPI was over 4% per year and in the early 1990s it reached over 9%. This would create a significant regulatory burden. Our preference would be threshold that includes RPI (or CPI/H in future).

In addition, we do not think a percentile target is a good measure of significance when it is applied to charges that are already very low. For example, our minimum charge for water is just under £94; an increase of £5 per year on this charge would require an impact assessment but is unlikely to have a significant effect on any household. When looking at changes on small bills in the first two years of AMP6 we have also looked at whether these would represent more than 5% of an *average* household bill.

It is also worth noting that the choice of 5% as the test of significance is somewhat arbitrary. Retaining this as the threshold for wholesale only has the effect of reducing that threshold compared to previous years (if wholesale is 90% of the overall bill, then this is equivalent to 4.5% on the total).

We think it will be important to review both the threshold and the scope of this assessment in future – particularly given some of the policy changes that Ofwat is considering. Our experience of non-household retail separation suggests that disaggregating customers' bills – and covering a minimum level of costs from customers – does lead to incidence effects, which will tend to be more significant for smaller customers.

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

In our view standardisation of wholesale charges would ease administrative burdens on retailers – and also MOSL - but is unlikely to provide significant benefit to customers overall. Therefore we think that Ofwat is right to take a cautious and measured approach.

The alignment of structures across regions would create winners and losers amongst the customer base, and could be disruptive to any business that suffers a significant increase as a result. It would not result in uniform charges across the industry, because regional price limits would still be different.

Retailers in the market when it opens will have to set up systems that are designed to cope with multiple wholesale structures; MOSL has done the same. These administrative costs are sunk. Future alignment would actually require more change to retail systems), so in the short term this might be a cost to both retail and wholesale. Only retailers entering the market after alignment is complete would reap full rewards.

In customer terms, alignment could benefit national organisations with sites in several regions. But where these customers have chosen to let a single contract for all of their water, their retailer should be able to provide an aggregated charge – taking away the complexity of regional charges is one of the ways in which a retailer can add real value for their customers.

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

We understand retailers would like to have certainty in order to put together their pricing strategy. This needs to be balanced against the burden this places on wholesalers: in terms of cost, assurance and the constraints on the final result. The latter is particularly important given that wholesalers are required to comply with a revenue cap, and face financial penalties if they fail to do so.

We think that the current requirements represent a reasonable compromise between these requirements. Wholesale charges cannot be finalised until November RPI is known, but it is important to recognise that other factors will cause movements in charges during the final quarter. In addition to customer volumes and numbers for primary charges, Ofwat's decision to include connection charges within the revenue cap also gives rise to some volatility. For example, companies need to predict the level of development activity that will occur and the rate of recovery (which is variable depending on whether there is existing infrastructure at development sites). This year, Ofwat is also consulting on significant changes to charges in this area which adds an extra degree of uncertainty.

That said, charges in the water sector are generally quite stable. Large incidence effects can be driven by regulatory changes but other rises tend to follow the rate of inflation (which retailers can observe) and price limits (which are published). There are few markets where retailers or customers have greater certainty over future pricing 8 months or more before they are put into effect. Genuine fixed prices are common in the energy market but retailers entering into these arrangements pay a premium in order to reduce their risk.

We think that the requirements for earlier publication (6 months in advance of charges) must not become more detailed than currently envisaged. While it is reasonable to give an indication of structural changes that might have a significant impact on customer bills, locking down charges earlier in the year would be extremely restrictive. This would not operate in the interest of customers or the market, as it would not enable wholesalers to respond to feedback from stakeholders (including retailers themselves) or any new charging rules that Ofwat might develop in the autumn.

If the objective is to provide more certainty in advance of the charging year, it is worth considering whether the measure of inflation could be changed in companies' Licences. In AMP7, when we move over to CPI/H inflation, Ofwat could take the opportunity to shift to an earlier month. The November rate is a proxy for annual inflation, taken from the closest publication prior to charges being published. Greater certainty in October could be provided by fixing at the August rate (which would be available a month prior to draft wholesale schemes).

*Impact on retailers (as distinct from end customers)*

The consultation asks wholesalers to assess the impact on retailers as a whole or in groups. We are unsure about the form of this assessment and it would be helpful if Ofwat could clarify this requirement. Our approach to date has been to calculate bill impacts for a representative range of end customers. We assume that competing retailers (when they begin to switch customers within the Severn Trent region) will have a broad range of customers, in which case the average increase in non-household wholesale charges would have an impact, although this would all be passed on to final customers.

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

As we have noted in response to previous charging consultations, the Board of Severn Trent would not be prepared to publish draft charges without adequate assurance.

Any Board assurance statement on movements between October and December must be limited to high level changes such as inflation or income from connection charges. Therefore, we think the emphasis on materiality to a reasonable person is the right approach:

- There may be small movements that have the effect of increasing the charges for a particular group of customers near the 5% threshold above that level. We would not expect to provide additional commentary on these (over and above the requirements for any increases above the threshold).
- When setting tariffs, companies operate under multiple constraints including price controls and compliance with condition E. The detailed mechanics of calculations such as the metered differential are complex and can be influenced by many variables. We do not think Ofwat would expect Board to comment on these interactions.

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

Like Ofwat, we think that revealing information can help better decision making. But transparent charges can only have a positive impact when customer decisions can help reduce costs or environmental impacts. We already publish separate charges for foul water, trade effluent and surface water drainage, because customers

can influence these charges – for example, by reducing the volume of waste water they discharge. Highway drainage is the only element of this proposal that is new.

Publishing highway drainage charges will not help retailers to control costs, because these costs are not caused by customers. They are driven by the investment decisions of agencies that do not pay sewerage bills<sup>2</sup>. The structure of sewerage charges cannot influence their decisions. In effect, this is a tax in kind.

As the cost is not driven by customers' property or consumption, there is no correct way to charge for this item. Given that all customers will use the road network to some extent, it is not clear how this tax can be levied fairly. Customers not connected to the sewer system cannot be charged for highway drainage, but still make use of the roads.

Two approaches have actually been employed in the industry to date – a flat rate and a link to surface area. Arguably, if there is no link to customers' sites or behaviour, a "poll tax" style approach could be adopted - but this would tend to fall more heavily on smaller customers. Adopting either of these approaches at a wholesale level will have an impact on customers – particularly those that do not already a separate charge for surface water.

Leaving to one side the fact that it is not apparent how retailers would be able to use this data, there are other ways of providing the information. For example one option would be to provide the relevant authorities and (potentially retailers) with an annual (published) report that sets out the costs that road agencies impose on the sector. Such a report would then provide a useful basis for engaging with these authorities on future investment plans.

If Ofwat introduces this rule, we think it should:

- Articulate the outcome that it is trying to achieve and evaluate the benefits it will create. We do not think that the consultation has made this case.
- Set out its view of the charging principles that should be applied in order to allocate the charge.

As part of any stakeholder engagement undertaken, we think that Ofwat should also test whether there is any significant demand for the separation of this charge. Our discussions with CCWater to date have indicated a shared concern that the publication of highway drainage charges will drive an increase in customer contact without delivering any benefit.

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

We are working to include non-primary charges within our Scheme and think that a minimum list is reasonable. Collecting these charges into one place is a new undertaking for most companies (including ourselves) and as part of this exercise we will be looking at the approach that others have taken. We think that there will be a degree of alignment in terminology as a result of companies' own initiative and there should be no reason for Ofwat to regulate in this area.

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

We think that the wording of our scheme will have to make clear that we are providing a list of standard charges, but that some services will have to be negotiated on an individual basis. For example, non-standard meter installations are – by definition – non-standard and we would have to take account of the actual costs in these cases. It is reasonable for us to set out some of the factors that could give rise to additional charges, but publishing an exhaustive list that covers all circumstances would be disproportionate – particularly given the low volumes involved.

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

The details of concessionary drainage charges and the groups which qualify are already set out within our scheme of charges. There is therefore no issue with replicating this information within a wholesale scheme and making the information available to retailers. It is possible for a property to qualify for one of these concessions if it changes use, and the occupant belongs to one of the groups qualifying under Government guidance.

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

We understand that we have an obligation to ensure that we do not impose a margin squeeze for any customer, including those on special agreements. Our wholesale charges for such customers will ensure that this is the case. In some instances, this makes for charges that will look unusual – being low or even negative. This is unavoidable given the need to fix prices to the final customer and ensure that retail charges can cover the retailer's cost.

In principle, there is no issue with publishing these charges. Our only concern is the extent to which this puts customer information into the public domain, given that each agreement relates to a single property. Since the information is relevant to retailers alone, it may be preferable to publish the information where it can be accessed by licensed retailers (via MOSL).

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

In our view, it would be problematic for wholesalers to be able to back-bill for a different (longer) period than retailers. Whichever route is taken to arrive at alignment, it appears to us that wholesale back-billing must be brought into line with market settlement period.

If wholesalers are limited to back-billing 16 months for non-households, a different arrangement for households could be showing undue preference to one group over another. While we believe this is a reasonable interpretation of Condition E, it may be preferable for Ofwat to codify the required approach within a charging rule for the avoidance of doubt.





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

Most NAVs set their end-user prices in line with incumbents. Other companies essentially established their wholesale rates by deducting average retail costs for serving each type of customer. While NAVs and Cholderton are not accustomed to accounting for retail separately, it does not appear unduly onerous for them to calculate their retail costs in order to establish a wholesale price.

Typically, NAVs have operated larger sites where they are able to take advantage of large user discounts; these provide them with an additional margin for operating local networks. Therefore, the NAV wholesale rate will differ from the wholesale charges which they pay to the incumbent provided they qualify for these discounts. As Ofwat is aware, Severn Trent is developing a new charge which is specifically designed to covers the costs of running on-site networks, so this should provide the basis for differences between our own wholesale rates and NAVs in our area.

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

We have set out our views on Board assurance in response to question 5.