Title: Guidance for Water Company Social Tariffs **IA No:** Defra1406 **Lead department or agency:** Defra **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 26/03/2012 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Other **Contact for enquiries:** kathryn.holdsworth@defra.gsi.gov.uk; 020 7238 5261

Summary: Intervention and Options

RPC Opinion: Awaiting Scrutiny

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
N/A	N/A	N/A	Yes	Zero Net Cost

What is the problem under consideration? Why is government intervention necessary?

A minority of water and sewerage customers struggle to afford their charges. This is a social issue which also results in increased revenue collection and customer contact costs to Water Companies. This has driven demand from the Water Industry and consumer groups to allow cross-subsidy between customers to fund 'social tariffs' which reduce the bills those with affordability problems. S44 of the Flood and Water Management Act is an enabling power allowing companies to create a social tariff, where they have a cost/benefit case and customer support. Under the Act, the Secretary of State has a duty to issue guidance - to which Ofwat and any company which opts to create a social tariff must have regard.

What are the policy objectives and the intended effects?

Social Tariffs will create equity benefits for customers genuinely struggling to pay their bills due to hardship. Participating Water Companies will improve revenue collection by presenting customers with a bill they are more likely to pay in full. This will reduce the burden of bad debt on paying customers. In addition, Water Companies see social tariffs as a mechanism for reducing the customer contact costs associated with affordability problems; and providing benefits in terms of reputation management. The guidance will enable S44 of the Flood and Water Management Act to come into force, in accordance with the Secretary of State's duty under the Act.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

An original assessment of the impact of social tariffs was cleared as part of the impact assessment of the Flood and Water Management Act 2010. This IA supplements that IA by examining the impact of issuing guidance to allow S44 of the Flood and Water Management Act to take effect. The guidance is necessary to allow companies to bring forward social tariffs should they wish to. The power to bring forward a social tariff is enabling not mandatory. This measure is an "IN" with a "zero net cost" to business. The measure is voluntary, but if a water company does choose to introduce a social tariff then it should meet the requirements set out in the light touch guidance. A water company will only introduce a social tariff where it makes commercial sense to do so. The only other option considered is not issuing the final guidance. This would prevent companies from bringing forward social tariffs and is in effect the baseline (do nothing option). This has no direct costs or benefits, so we have not created a policy options page for this option.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 04/2016

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY: .... Date: ....

Summary: Analysis & Evidence Policy Option 1

Description: Issue guidance to allow Section 44 Flood and Water Management Act (social tariffs) to take effect

FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: N/A	**High:** N/A	**Best Estimate:** N/A

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low				
High				
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised costs by 'main affected groups'

It is not possible to monetise the aggregate costs of issuing the guidance, given the significant variation in the size of different water companies' customer base and level of bills. Each water company will perform its own impact assessment of whether a social tariff is appropriate, cost-beneficial and commands the support of its customer base. In response to our consultation, companies indicated that they would individually assess the cost benefit case for bringing forward a social tariff.

Other key non-monetised costs by 'main affected groups'

Where companies, in consultation with customers, elect to put social tariff schemes in place there will be costs associated with consultation, gathering evidence, developing proposals, promotion, publication and running the scheme (beyond existing charging activity). Evidence gathered during consultation suggests that start-up costs might be in the range of £0.04 to £1.22 per customer (across the whole customer base), with running costs in the range £0.03-£0.29 per customer per annum thereafter.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low				
High				
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised benefits by 'main affected groups'

As for costs, it is not possible to monetise benefits since decisions about the size of and eligibility for any social tariff will be for individual companies. Water Companies vary signficantly in terms of the size and profile of their customer base and the size of their bills. In general however, rational companies will only choose to develop schemes (in response to the guidance) where benefits exceed costs. Social tariffs will onlt be approved where companies can demonstrate customer support.

Other key non-monetised benefits by 'main affected groups'

Potential benefits to companies from developing social tariff schemes include better revenue collection and reduction of bad debt levels, and cost savings from reduced contact with non-paying customers and those struggling to pay. Wider benefits include improved reputation for companies and reduction of financial hardship for those who struggle to pay their bills. Customers may also benefit from better customer service resulting from companies' improved understanding of their customer base.

Key assumptions/sensitivities/risks **Discount rate (%)** n/a

"Per customer" costs are per person served. Costs have been generated from a sample of several water companies responding to the consultation and are assumed to be representative. Companies are able to determine through analysis whether social tariff schemes will be cost-beneficial before incurring most of the development and running costs above (a couple of companies already have a view that schemes would be cost-beneficial).

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	Yes	Zero net cost

Evidence Base

Introduction

The water and sewerage industry in England and Wales was owned and operated by the state until privatisation in 1989[1]. Following the purchase of then state owned water boards private companies were licensed to own and operate the assets of these companies, providing water and sewerage services to customers and recovering the costs of providing those services to customers by billing them directly. Water and sewerage services have both ‘essential service’ and ‘natural monopoly’ characteristics. Water and sewerage services are ‘essential’ in that they are critical to sustaining life. The economic regulator, Ofwat, regulates the total revenue that companies are permitted to recover from their customers.

The legislation and the licence which is provided to companies gives them exclusive privilege to provide water and sewerage to virtually all of the customers in their area ‘source to tap’. This ‘natural monopoly’ structure provides certain risks which also need to be managed by economic regulation. In particular, without the competitive pressures that arise in markets, the monopoly has a range of negative incentives which must be managed, including incentives to overprice (or undersupply), operate inefficiently, fail to innovate and price-discriminate between different groups of customers (based on their ability to pay and their elasticity of demand for water).

As the independent regulator, Ofwat protects customers and ensures that companies can finance and carry out their functions, whilst earning a reasonable return on their capital. Through regulation it also manages the negative incentives which could occur in the absence of competition. Ofwat does this by setting price limits for water and sewerage companies. These cap the maximum amount each company is able to charge its customers as a whole. Price limits are determined by working out how much revenue each company must collect from its customers to run their businesses efficiently, for example in order to supply water, build and maintain infrastructure and to serve customers through billing, contacts and debt recovery.

At Price Review, Ofwat sets a five year price cap to which the rate of inflation is added annually. As part of this process, Ofwat compares the performance of the companies to determine what constitutes an efficiently run business. Companies have an incentive to outperform their efficiency targets since this generates a profit for them. At the subsequent price review Ofwat then reflects these efficiency gains by reducing the companies’ revenue limit and so lowering bills to its customers. This driver for increased efficiency recreates the dynamics of a competitive market and helps keep a downward pressure on customers’ bills.

Each year, companies prepare a charges scheme setting out all their tariffs and their estimates of take-up. The charges schemes must comply with the companies’ revenue allowance. Ofwat regulates charges schemes. As a condition of their licences, companies are not permitted to unduly discriminate in the charges they set for different customer groups unless this is set out in legislation. This is the purpose of S44 of the Flood and Water Management Act. It is an enabling power allowing companies to create a social tariff for the purposes of affordability, where they have a cost/benefit case and customer acceptance.

In 2012/13 the average annual household bill is £376. This ranges from £325 (Severn Trent) to £543 (South West Water). Charges for individual customers vary according to the amount of water they use (if they have a meter) or the rateable value of their home.

Problem under consideration

Despite Ofwat’s role in ensuring that bills remain affordable, some customers struggle to afford their water and sewerage charges. Around 23% of the customers in England and Wales pay more than 3% of their disposable income on water charges and 11% of households pay more than 5% of their disposable income - 2.5 million households. This has a social impact for those customers. Since privatisation, water

[1] A summary of the history of the water and sewerage industry can be found at: http://www.ofwat.gov.uk/publications/commissioned/rpt_com_devwatindust270106.pdf

and sewerage bills have increased by more than 40% in real terms. Affordability problems have a negative social impact for those customers, increasing their prospects of falling into debt and experiencing problems paying for other essential goods and services.

There are also wider impacts; although some struggling customers continue to pay their bills, others do not. Ofwat research shows that there is considerable overlap between customers likely to have affordability problems and water debtors. Research repeatedly finds that water debt is more likely for low-income single households, and lone parents and families. This reflects the profile of those with affordability risks. This leads to increasing bad debt, higher levels of customer contact (chasing customers with telephone calls and letters) and decreased revenue collection. Water companies have a duty to supply water and sewerage services to customers but no corresponding right to disconnect customers for non-payment of bills. They incur costs when customers do not pay their charges: costs associated with debt collection activities; bad debts that are written off; and costs which companies incur when customers do not pay their bills on time (e.g. the interest and borrowing costs on finance required to replace the outstanding revenue).

The level of bad debt in the water industry is approximately three times higher than that of the energy sector, despite water and sewerage bills being around a third of the cost of average energy bills. Since the Water Industry Act 1999 came into effect and withdrawal of service through disconnection has been prohibited, there has been a sharp increase in the level of outstanding revenue from domestic water customers: from £705 million in 1998-99 , to £1.635 billion in 2010-11. The industry wrote off approximately £328 million of household debt in 2010-11, an increase of £168 million from the previous year.

Bad debt places a cost burden on both water companies and their customers. Paying customers bear the cost of bad debt to the extent that Ofwat permits when it sets its five yearly price limits. Ofwat sets efficiency targets for revenue collection and permits companies to collect revenue to cover the costs they incur for efficient debt recovery practices. A water company can increase its profit margin by outperforming against projected revenue collection. Conversely, increasing levels of non-payment puts an upward pressure on companies' revenue collection costs and debt financing costs as well as having a negative impact on cash flow. In 2011/12, the cost of bad debt to paying customers is equivalent to £15 per household or 4% of the average water and sewerage bill. Some customers with affordability problems will continue to pay their bill. The additional cost of bad debt places a further burden on these already vulnerable customers.

Ofwat research found that paying customers resent paying the costs of bad debt. There could also be consequences for a company's financial position. If companies are unable to recover costs in a reasonable time, they may lack the cash needed to run the business and may need to raise additional cash from investors, for example, by borrowing extra money. An increase in bad debt beyond debt forecast at Price Review reduces a company's profits and makes a business less attractive to investors which could make it more difficult and expensive to invest in improving and maintaining drinking water supplies and the environment. The cost of bad debt to individual water companies is classed as commercially sensitive information, so we do not have figures for the impact of bad debt on companies' profits.

Water and sewerage companies often nickname those in debt as “can't pays” and “won't pays”, acknowledging that some debtors cannot afford their charges and some debtors are choosing not to pay either as a principled stance, because they perceive there are no consequences to non-payment, because they forget or are unaware of their liability for the bill. Government is examining options for tackling bad debt amongst “won't pay” customers who can afford to pay but do not. Often water companies do not have details of people occupying the properties they supply. We are investigating measures to close that information gap.

Water companies already try and support struggling customers to some extent through payment plans, referral to debt and benefits advice and trust funds. Some companies already use “win win” tariffs (tariffs which are not reliant on cross subsidy and so already allowed under the current rules). By publishing social tariff guidance and allowing companies to create social tariffs which are funded by cross-subsidy by other customers we are providing companies with “another tool in the toolkit” to support and engage customers who struggle to pay their bills.

We would expect the guidance to enable companies to introduce social tariffs which make a meaningful reduction in bills. For example, Citizens Advice bureaux assess customers’ ability to pay for Wessex Water’s “Assist” Tariff (a “win win” tariff targeted at those who cannot pay their bill in full) and Wessex have found that customers on Assist consistently pay more money than they were doing before and get into a regular payment routine which benefits the company and other customers through increased revenue. As Wessex Water say, “there is no point in giving a customer a bill they cannot afford”. The ability to offer social tariffs can therefore help increase revenue from customers who are currently not paying. It also helps to drive down the costs of engaging with those customers who are struggling to pay their bills.

<u>Rationale for Intervention</u>

There have always been many, complex cross-subsidies inherent in water charging including between urban and rural customers and as a result of charging by reference to the rateable value of a customer’s home. As more customers start to pay for their water by reference to volume, some of these cross-subsidies are unwinding.

Under current regulatory arrangements, companies are not permitted to introduce social tariffs unless specified in legislation. Whilst some companies have introduced win-win tariffs the scale of the subsidy is restricted to what can be funded by the company through direct savings made in debt recovery costs. Because their objective is to manage debt costs more efficiently, the tariffs tend to be targeted at debtors. Whilst there are significant overlaps between debtors and those with affordability problems, they are not always the same. The issuing of guidance to permit social tariffs will enable companies to make more meaningful reductions in bills and to widen eligibility to those who struggle to pay but are not debtors. Companies will be able to target support at those most in need in their company area. This rationale underpinned Section 44 of the Flood and Water Management Act 2010.

Section 44 of the Flood and Water Management Act 2010 enables water and sewerage companies in England and Wales to include social tariffs in their charges schemes, reducing charges for households who would otherwise have difficulty in paying their bill in full. It explicitly allows for cross-subsidy between customers. More details are provided in Box 1.

The provisions of Section 44 can only take effect if the Secretary of State issues guidance to companies on the operation of social tariffs. The rationale for intervention is therefore to allow Section 44 to come into play.

Box 1 Section 44 of the Flood and Water Management Act 2010

“(1) An undertaker's charges scheme under section 143 of the Water Industry Act 1991 may include provision designed to reduce charges for individuals who would have difficulty paying in full.

(2) Subsection (1) includes schemes which have the effect of subsidisation by other persons.”

The Act requires the Secretary of State to issue guidance to water and sewerage companies and Ofwat, and requires companies and Ofwat to have regard to the guidance. The Act states:

(4) The Minister must issue guidance in respect of subsections (1) and (2) which must, in particular, include factors to be taken into account in deciding whether one group of customers should subsidise another; for which purpose the Minister shall have regard to the need to balance the desirability of helping individuals who would have difficulty paying in full with the interests of other customers.

(5) Undertakers and the Authority shall have regard to any guidance issued by the Minister under subsection (4).

(6) “The Minister” means—

(a) in the case of an undertaker whose area is wholly or mainly in England, the Secretary of State, and

(b) in the case of an undertaker whose area is wholly or mainly in Wales, the Welsh Ministers.

Policy objective

We now wish to allow S44 of the Act to come into force, by issuing final guidance, fulfilling the Secretary of State's duty. Whilst technically, S44 of the Act is already in law, as water companies must have regard to the Secretary of State's guidance, they are unable to include a social tariff in their charges scheme until the guidance has been issued. The guidance will allow companies to legally create social tariffs without being in breach of their licence condition stating they must not show undue preference or discrimination to any customers. The inclusion of cross subsidies in a social tariff which complies with this guidance will not in itself constitute undue discrimination or preference. The only other policy option considered is not issuing the final guidance and therefore not allowing companies to use this measure.

The impact of the power for companies to create social tariffs was first assessed in an impact assessment supporting the then Flood and Water Management Bill in 2009 http://archive.defra.gov.uk/environment/flooding/documents/policy/fwmb/fwmia-summary.pdf. There was an addendum on S44:
http://archive.defra.gov.uk/environment/flooding/documents/policy/fwmb/fwmiaconcess-surface.pdf

The current IA has been prepared to support the decision to now issue the final version of the guidance. This follows a consultation to water companies and other stakeholders on draft guidance which ran between 26 October 2011 and 17 January 2012, during which views were submitted by water companies and others.

In response to the consultation on the draft guidance, companies welcomed the draft guidance and commented that it would be a useful tool for addressing water affordability problems. In particular they welcomed the light-touch approach taken by the guidance the flexibility it provides to allow companies to develop locally-appropriate social tariffs. Most companies said they would consider the cost/benefit case for developing proposals upon which they would then consult their customers. Water UK, responded on behalf of the industry to call for Government to issue the guidance as soon as possible. Companies have identified that there are likely to be benefits in terms of reduction of bad debt and associated costs, increased revenue and reduced customer contact. More broadly, companies have commented that they would expect benefits to include better customer service and relationship with customers, reputational benefits and having another tool with which to engage customers who find it difficult to pay.

The measure in the Flood and Water Management Act is enabling and not mandatory. Water companies do not have to create a social tariff but if they do choose to do so then they must have regard to the guidance. The water industry has commented that they will not create a social tariff unless they consider it is likely to have a net benefit for them. They have also explained that they would incur most of the costs associated with following the guidance in the course of their usual business of designing their charges scheme. This IA therefore assesses the additional costs that a water company would face as a result of choosing to bring forward a social tariff and having regard to this guidance.

More discussion of costs and benefits is presented later in this IA.

The Guidance

There was some choice as to the approach taken in the guidance, though the Act specifies some factors which must be included (notably on approaches to cross-subsidy; see above). The decision has been made to allow companies as much freedom as possible to design tariffs appropriate to their customers.

The final guidance states that while setting the policy and legislative framework for social issues, including water affordability, is the responsibility of Government, water companies are best placed to design their own social tariffs. They will be able to do so as part of their charges schemes and take account of local circumstances, needs and the views of their customers. The guidance allows water companies scope to design the most appropriate tariff for them.

The final guidance does not specify eligibility criteria for social tariffs, the level or type of concession which should be made or the amount of cross-subsidy from other customers that can be used to fund a scheme. Instead, it provides guidance on all of those elements and makes suggestions for options which companies could consider. It allows companies to design schemes in consultation with their customers and organisations which represent customers like Consumer Council for Water. It states that schemes should be broadly acceptable to the customer base and that this should be evidenced through engagement with customers. It explains that proposals will need to be underpinned by an assessment of the impact of the social tariff. It says that Ofwat will approve social tariffs as part of their regulation of companies' charging schemes. It provides proportionally more guidance on the issue of cross-subsidy. This states that it is Government's view that a charge of up to 1.5% of the average annual household water bill would be a reasonable amount of cross-subsidy to expect non-qualifying households to provide (around £5 in 2011/12).

In response to the consultation on the draft guidance, water companies welcomed the flexible approach taken and the focus on allowing water companies to design schemes to address local needs in consultation with their customers. In response to a previous consultation on broader affordability issues (which ran between April and June 2011 and sought initial views ahead of the consultation on the draft guidance), most respondents were in favour of Government providing a broad framework and then companies and their customers taking decisions on issues such as cross-subsidy and the level of concession.

An alternative option would have been to draft stricter guidance which dictated who should be eligible, the level of concession to be provided and the level of cross-subsidy to be permitted. However, dictating the conditions of a tariff in this way would not have been compatible with the spirit of the Act to enable companies to bring forward tariffs should they feel this would be beneficial to their customer base (or the responses received to the affordability consultation). That approach would be more compatible with a universal scheme which all companies were forced to bring forward. This is not a provision in the Act and was therefore not considered an appropriate approach.

In the consultation, companies stated that the main costs incurred would be through consulting customers on tariff design and through promotion. We did consider an alternative option of a version of the guidance which contained no such obligations to consult, to minimise cost. Its downside, however, given the enabling and broad scope approach of the current draft guidance, would be lack of credibility and buy-in from customers. The final approach to guidance strikes a balance between cost to companies and acceptance by customers.

Costs and benefits

During consultation, a number of water companies responded to a request for evidence on the costs and benefits of the proposals.

Costs

There are 22 water and water and sewerage companies in England and they vary widely in terms of size, turnover and customer base. The smallest, Cholderton Water, supplies around 2,000 people in an area of around 21 square kilometres through some 800 service connections and is a water only supplier. At the other end of the spectrum, the biggest company, Thames Water serves 14 million customers with sewerage services and supplies water to 8.8 million customers.

Reflecting this diversity, the evidence on the likely cost of introducing and running a social tariff scheme varied according to the company submitting information. We have therefore provided indicative, illustrative figures to show costs as it would not be appropriate to gross up costs England-wide.

As would be expected, the biggest variation was by size of company (in terms of population served). Start-up costs ranged from an average of £85k for the two "smallest" respondents, to an average of £3,353k for the two "largest". The average start-up cost for smaller companies (with a population base below 3m) was £157k, and that for larger companies (above this threshold) was £1,754k. However, when costs were expressed per person served, the range across all respondents was between £0.04 and £1.22. This compares with an average household water and sewerage bill of £356 in 2011/12. Assuming each household has, on average, three persons, the average addition to a household bill is therefore in the range 0.03-1.03% (note there is a statement in the guidance that costs within 1.5% might be reasonable, depending on benefits). It should be noted that these figures do not make any allowance for the customer base likely to be the beneficiaries of social tariffs (who would presumably not pay these costs, meaning the impact for other customers would be slightly higher). Excluding the highest-cost company from the results however (where there was a question surrounding whether quoted staff costs were only those applying just to a marginal decision to advance a social tariff scheme) leads to the range of start-up costs per person served being within £0.04 and £0.15.

Ongoing annual running costs of social tariff schemes ranged from an average of £23k for the two companies with the smallest population bases, to £726k for the two with the largest. The average ongoing cost for smaller companies (with a population base below 3m) was £23k and that for larger companies (above this threshold) was £477k. When again expressed as costs per person served (but noting the caveat relating to social tariff beneficiaries set out above), the range across all respondents was between £0.03 and £0.29. Assuming three persons per household and a £356 average annual water and sewerage bill as before, this implies a proportionate addition to a household bill of between 0.03-0.24%. As for the startup costs however, one responding company had staff costs which seemed to represent an outlier, and excluding this respondent brought the range down to £0.03-0.05 per person served.

A proportionate breakdown of per-company costs by item, averaged across the sub-set of respondents which provided sufficient detail, is provided below.

Category	Startup cost in year 1	Annual ongoing cost
Consultation with CCWater and others on approach		
Gather evidence, develop draft proposals/ options	8%	14%
Liaise with CC Water on draft proposals/ actions		
Consult customers (including press notices)	2%	
Respond to consultation and finalise proposals	1%	
Consult CCWater and others on final proposals		
Submit to OfWAT for first time approval		
Promotion	5%	8%
Review, analyse and publish results of social tariffs	1%	
Running costs	70%	56%
Additional costs	13%	22%
Total	**100%**	**100%**

In general, respondents indicated that many of the processes associated with introducing social tariffs would be completed as a matter of course by water companies as part of wider exercises to establish charges, meaning that the marginal (extra) cost of a social tariff proposal would be zero or small. This is reflected in the above table, where a number of items are left blank to signify zero extra costs. The main cost items respondents identified were running costs (generally staff), followed by evidence-gathering and tariff development, and promoting schemes to customers.

Benefits

The wider benefits through bringing forward a social tariff were discussed in the initial IA of the measure in the Flood and Water Management Act. They include the benefit of reduced bills for the poorest customers who struggle to pay their water charges and the benefit of reduced bad debt and associated chasing costs and reduced customer contact for water companies.

If social tariffs help to prevent new bad debt as well as help customers who struggle to pay, we would expect a reduction in the calculation of the costs of debt per customers. This also gives a time-limited benefit to companies. If a company collects more debt than is forecast, they retain this additional revenue as profit. This means that between price reviews, increased revenue will lead to a financial benefit to the company (but no extra cost to customers), and in the following Price Review period there will be a financial benefit to customers (but no extra cost to the company). At the subsequent price review Ofwat then reflects these efficiency gains by reducing the companies' revenue limit and so lowering bills to its customers. This driver for increased efficiency recreates the dynamics of a competitive market and helps keep a downward pressure on customers' bills.

It is important to remember, however, that some customers are currently paying their water bill despite the fact that they are struggling to do so. Eligibility will be linked to affordability rather than failure to pay. Water companies will be designing schemes, including eligibility criteria. This means that social tariffs will also reduce bills for customers who are currently paying in full despite having difficulty doing this. Although this implies some “deadweight” in narrow financial terms (as a social tariff is not strictly necessary for revenue collection in such cases), in economic terms this could lead to an improvement in economic welfare through redistribution.

Companies have commented that they will not create social tariffs unless they assess there will be a net benefit to them. It should also be noted that companies will only be able to launch social tariff schemes where they have the broad acceptance of the customer base. Companies have identified that there are likely to be benefits in terms of reduction of bad debt and associated costs, increased revenue and reduced customer contact. More broadly, companies have commented that they would expect benefits to include better customer service and relationship with customers, reputational benefits and having another tool in the toolkit with which to engage customers who find it difficult to pay. Companies are financially rewarded or penalised for the quality of their customer service through Ofwat’s Service Incentive Mechanism which examines customer satisfaction.

Several companies are now rolling out programmes of universal metering. This will see approximately half customers’ bills rise and half fall. Companies carrying out such programmes are especially keen to be able to offer social tariffs as a way of engaging struggling customers. In the guidance we state that it is Government’s view that companies which introduce universal metering should seriously consider the benefits of a social tariff scheme to address long term affordability issues which may arise from the unwinding of cross-subsidy inherent in rateable value charging.

There were very few responses to consultation which included *numerical* estimates of potential monetary benefits to water companies (and in turn their wider customer base) from social tariffs. This is to be expected given that schemes have generally not yet been designed. However, two companies did provide some tentative results of early investigations which suggested that monetary benefits of potential schemes were likely to exceed startup and running costs, and that these benefits were likely to be in the areas of increased revenue and reduced customer contact costs.

<u>Risks and Assumptions</u>

All costs are on the assumption that a company decides to create a social tariff. In the example above the water company has assumed a light touch and common sense interpretation of the guidance, i.e. consultation with customers through qualitative and quantitative market research and promotion largely through existing routes. A company may decide to conduct more costly consultation and promotion.

As it is very unlikely that a company would make part of the eligibility criteria for a social tariff a history of non-payment of bills, there will not be an incentive for more customers to default on their payments. We therefore do not think there is any risk of more customers defaulting on payments as a result of the social tariffs guidance.

<u>Direct Costs and Benefits to Business Calculations</u>

The guidance and associated provision in Section 44 of the Flood and Water Management Act are enabling. Companies are under no obligation to develop a social tariff. As such, there are no imposed direct costs to business from the proposal to issue guidance. Furthermore, companies will rationally only pursue social tariffs where benefits to them exceed costs.

<u>Wider Impacts</u>

The wider impacts are the benefits of the existence of social tariffs as discussed in the benefits section above.

There are two systems of charging for water – according to volumetric use (via a water meter) and according to the rateable value of a customer’s home. Around 37% of customers are currently metered. All customers have the right to opt for a meter. Metering can reduce the bills of some customers (often if they are single or live in a couple, especially if they live in a property with a higher rateable value), but can increase the bills of some customers (for example, of customers who use a lot of water and of bigger families living in homes with lower rateable values).

The guidance makes it clear that social tariffs can be used by companies to reduce the bills of customers regardless of how they pay, so could apply to metered and unmetered customers. The guidance encourages companies to promote metering as an affordability measure and states that companies should include advice on metering and efficiency and other aspects of affordability as part of its promotion of a social tariff. It explains that possible concessions could include a percentage discount on bills, a free or discounted block of water per child for metered households with children, a flat rebate or a cap on bills. It explains that Government would prefer not to see a cap on bills as the preferred concession for large numbers of qualifying metered households in areas of serious water stress. We would expect companies in areas of serious water stress to be mindful of avoiding incentives to increase demand of water and design schemes which do not encourage excessive use of water.

Implementation Plan

We plan to issue final guidance in time to allow companies to bring forward social tariffs in their 2013/14 charges schemes if they wish to do so. This is a challenging schedule which will become increasingly so as the publication of guidance gets closer to the deadline for companies submitting their charges proposals to Ofwat (November 2012). Companies have expressed that the burdens on them increase the less preparation time they have available after publication of the guidance.