

Charging principles

November 2013

These principles will underpin the development of the *Charging Guidance* that the Government will issue to Ofwat to establish the framework for the market reforms contained within the Water Bill.

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1. Background: reforming markets for water and sewerage services

1.1 Since privatisation, the stable regulatory framework underpinning our water industry has enabled the sector to attract over £111 billion in low-cost finance which has been used to upgrade water and sewerage infrastructure, improve customer service, drive up water quality and achieve environmental goals. Regulation is designed to ensure that all investment by water companies is undertaken efficiently and in the interests of customers. We must retain the strengths of this system whilst ensuring that it can continue to evolve to keep bills as low as possible whilst meeting future challenges.

1.2 Change is needed to respond to increasing pressures on our water resources and the resulting implications for the water environment and customer bills. In order to manage these pressures as effectively as possible we need to harness the benefits of competition alongside existing regulatory incentives. The majority of water and sewerage services will continue to be provided by integrated, monopoly suppliers. However, there is significant scope to capitalise on the benefits of competition in customer services and activities to drive water efficiency as well as in the provision and treatment of water resources. We need to grasp these opportunities to ensure that customer bills are kept fair for the long-term.

1.3 This Bill responds to demand from businesses, charities and public sector customers in England who want to be able to switch their supplier. The introduction of retail competition offers significant benefits to a wide range of organisations including those seeking more tailored customer service or advice on water efficiency. Customers with more than one premises could save thousands of pounds in administration costs by dealing with only one water company. These reforms will not directly affect household customers, because competition is being introduced only for business customers. However, increased competition will encourage innovation and resilience of supply which will help keep bills affordable for everyone.

1.4 Our 'upstream' reforms will encourage new companies to enter the water sector who might offer new water sources, water efficiency goods and services or innovative ways for dealing with wastewater and sewage sludge. They will also make it easier for water companies to trade water with each other, increasing flexibility in the system, particularly during periods of drought. These reforms will benefit customers and the environment.

1.5 We will introduce these reforms in a measured, evolutionary fashion; recognising the importance of stability for customers, for water companies and for their investors. Implementation of these reforms will require consideration of a wide range of detailed charging matters. To ensure continuing stability in relation to charging, the Bill provides for the Government to issue *Charging Guidance* to the regulator. This will set the scope for

Ofwat's *Charging Rules* governing the new competitive markets and establish the basis for water companies' charges schemes.

2. Context: charging guidance and charging rules

2.1 Government is committed to providing a clear policy framework for the developing retail and upstream markets and to guide the way in which Ofwat regulates them. However, we have learnt from experience that prescribing too much detail on the face of legislation can stifle competition and prevent markets evolving. The approach taken in this Bill enables us to work closely with the regulator, market participants and other stakeholders in developing and shaping the new markets, and fine-tuning that approach as we learn from experience.

2.2 We amended the Bill following pre-legislative scrutiny to make it a duty for ministers to produce charging guidance to Ofwat. This new duty will ensure that ministers clearly set out Government policy to which Ofwat must have regard when preparing its charging rules. The guidance will embrace all relevant charging matters; establishing a clear framework governing both the companies' schemes for charging end users and the new competition regimes.

2.3 The guidance will need to reflect the debate in Parliament, and build on work that is being done to prepare for implementation of market reform, both in Ofwat and through the High Level Group. It will be issued in draft form for formal consultation with all interested parties. The Bill provides Parliament with the opportunity to debate and vote upon the charging guidance following that consultation process.

2.4 The Government recognises that early visibility of the principles that will shape the guidance will help reduce uncertainty and inform debate during the passage of the Bill. The charging principles set out in this document will underpin the development of the Government's *Charging Guidance* to Ofwat and establish the boundaries for Ofwat's charging rules. The Government's approach to charging will need to evolve as the market develops; however, the intention is that the direction set by these broad principles will stay in place for around a decade while the retail and upstream measures in the Water Bill are implemented.

2.5 The new *Charging Guidance* to Ofwat will replace existing charging guidance issued in 1999 which sets the scope for the current charges schemes. It will sit within the context of other Government guidance to the regulator including the Government's *Strategic Policy Statement to Ofwat* and the *Social and Environmental Guidance* which set out the Government's expectations for economic regulation of the water and sewerage industries. The detailed terms of the charging guidance will need to be kept under review, for example to reflect future price controls.

2.6 The purpose of these high level principles is to inform debate by providing a clear steer regarding the Government's proposed approach to charging. We welcome any comments you may have regarding these principles. Please send your comments to waterwp@defra.gsi.gov.uk

3. Charging Principles

3.1 Government wants charges in the water sector to:

- Represent a fair deal for all customers – charges should be stable, transparent and affordable.
- Better reflect the costs of supply, increasing the long-term resilience and sustainability of our water resources.
- Facilitate a more competitive sector, providing space for both incumbent water and sewerage companies and new entrants to the market to innovate in order to deliver benefits to customers.

1. Household customers must continue to be protected through the price control process. They will not subsidise the development of competitive markets for business customers.
2. Charges will need to evolve over time, and any transition to an improved reflection of resource costs in the competitive part of the market must be delivered in a measured way and regulated to ensure that all customers face predictable and stable charges.
3. No category of customer should be unfairly disadvantaged by the way reform impacts on water charges. A fair and non discriminatory approach to sharing network costs will be critical. For example, rural customers must continue to be protected.

The charging regime must support delivery of the Government's approach to investment in water and sewerage services, ensuring an attractive environment for investors and minimising any risk that water and sewerage companies would be unable to recover the costs of efficient investment.

5. The charging regime must enable new entrants to compete on level terms with incumbent companies.
6. The charging regime must ensure that the implementation of the market reforms set out in the Water Bill complements environmental protections. The evolution towards more cost-reflective pricing of water resources in the competitive part of the market will help to drive innovation and improve recognition of environmental costs.

1. Household customers will continue to be protected through the price control process They will not subsidise the development of competitive markets

- The introduction of greater competition into parts of the market is designed to improve water company performance; driving efficiency and improving customer service for both household and business customers.

- Being able to switch suppliers will increase the bargaining power of business customers; and those who choose not to switch suppliers will have the security of regulated default tariffs.
- Ofwat will continue to use the Price Review process to protect households and ensure that the charges they pay are fair and transparent.
- Households will not pay for the implementation of the competitive market. Ofwat will require the incumbent companies to publish separate, audited accounting information for the competitive and non-competitive parts of the market and take action if they consider any undue price discrimination has taken place.
- In addition, in response to Government guidance, a growing number of companies are implementing Social Tariffs to help vulnerable households at risk of affordability problems.

2. Charges will need to evolve over time, but any transition to an improved reflection of resource costs in the competitive part of the market will be delivered in a measured way and regulated to ensure that all customers face predictable and stable bills.

- We know that the stability and predictability of bills is important to customers. Ofwat will continue to regulate in order to minimise the price volatility and to protect those non-household customers that choose not to switch by establishing default tariffs. Household customers will retain the protection of the Price Review process and other regulatory provisions.
- Ensuring that the water charges paid by customers in the competitive part of the market reflect the true costs of supplying that water is good for customers and good for the environment. Over time it will encourage greater efficiency and more sustainable use of our water resources.
- Increased competition will provide new opportunities for non-household customers to negotiate improved levels of service and potentially to encourage the identification of lower-cost sources of water.
- Averaging of charges is common practice in sectors that have much greater scope for contestability than the water sector does. Ofwat has a number of tools to limit the effect of de-averaging on customer charges. They will use these to ensure that any marginal changes are introduced in a measured fashion and, above all, that they are in the overall interests of consumers.

3. No category of customer should be unfairly disadvantaged by the way reform impacts on water charges. A fair and non discriminatory approach to sharing network costs will be critical. For example, rural customers must continue to be protected

- The companies' universal service obligations remain unchanged and will be reflected in the Government's Charging Guidance and the regulator's Charging Rules.
- Ofwat is required to secure that no undue preference is shown, and that there is no undue discrimination in the fixing of charges. They must also utilize their regulatory tools to protect rural customers and others that may be more expensive to serve.
- Any non-household customers that opt not to switch suppliers will have the ongoing security of default tariffs, to ensure that the charges they pay remain fair and transparent.

4. The charging regime must support delivery of Government's approach to investment in water and sewerage infrastructure, ensuring an attractive environment for investors and minimising any risk that water and sewerage companies would be unable to recover the costs of efficient investment

- Companies will continue to be able to recover the costs of efficient investment. The Government's statutory guidance to Ofwat: the *Strategic Policy Statement* establishes that the regulatory regime must continue to enable efficient, integrated companies to achieve an appropriate return on their assets.
- Ofwat has made a commitment that the key concept of regulatory capital value (RCV) will continue to be reflected in the wholesale price controls to provide transparency and predictability for investors.
- The changes we are making should be a spur to companies to ensure that all future investment is undertaken as efficiently as possible and with the interests of current and future customers to the fore. These reforms will ensure that customers are not expected to pay for inefficient investment.

5. The charging regime will enable new entrants to compete on level terms with incumbent companies.

- Creating a level playing field to enable new entrants to compete with the existing water companies for the provision of retail services, such as billing and customer contact will support the Government's objective of a more customer focused water industry and will create opportunities for businesses, charities and the public sector to make significant savings by switching to a single supplier for sites across the country.
- Creating a level playing field to enable new entrants to compete with the existing water companies for the provision of "upstream" services, such as the sourcing and treatment of water and the disposal of sewage will promote more efficient and innovative use of scarce water resources and make it easier for water companies to trade water with each other.

6. The charging regime will reflect the overarching requirement for the new markets to complement environmental protections. The evolution towards more cost-reflective pricing of scarce water resources in the competitive part of the market will help to drive innovation and improve recognition of environmental costs

- Increasing cost reflectivity in the competitive parts of the value chain could have significant long term benefits. For example, if a very large water user is making a decision about where to locate new premises, it would make sense for them to consider the benefits associated with areas where water is plentiful. Currently, such incentives are minimal.
- The implementation of upstream markets is just one aspect of the Government's wider agenda for securing the long-term resilience of our water supplies and the water environment, which was set out in the Water White Paper. This includes, for example, the statutory water resources management planning process and our plans for reform of the abstraction regime. The common theme across this agenda is our commitment to achieving the right balance between long-term planning, environmental regulation and the use of market mechanisms to secure the most efficient use of scarce water resources.
- Implementation of reforms to the upstream and abstraction regimes will move forward in parallel to ensure that economic incentives and environmental protections are well aligned with the Government's policy objectives.

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<https://www.gov.uk/government/policies/reforming-the-water-industry-to-increase-competition-and-protect-the-environment>

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