

Title: Changes to approval process for Water Company charges schemes IA No: Defra1455 Lead department or agency: Defra Other departments or agencies: Welsh Government, Ofwat	Impact Assessment (IA)		
	Date: 25/04/2012		
	Stage: Final		
	Source of intervention: Domestic		
	Type of measure: Primary legislation		
Contact for enquiries: Tim Brooks 0207 238 5256			
Summary: Intervention and Options			RPC Opinion: AMBER

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, Measure qualifies as One-Out?
0	0	0	Yes Out

What is the problem under consideration? Why is government intervention necessary?
Legislation requires that all water companies have their charges scheme approved by Ofwat each year (this is in addition to the 5 yearly Price Review which caps charges). Water Companies see this as a barrier to tariff innovation. Ofwat regards it as a barrier to light-touch regulation, placing unnecessary burdens on compliant companies and encouraging behaviours driven by the regulator rather than the customer. The Gray review of Ofwat recommended reducing regulation in the water industry and incentivising more innovative, customer-focused behaviours. The Water White Paper responded with commitments to support Ofwat to reduce regulation and promote greater innovation.

What are the policy objectives and the intended effects?
Gray encouraged Ofwat to keep “the regulatory burden associated with charging to a minimum” and encourage water companies to “feel more ownership of their business plans”. In line with this, Ofwat wish to move to a risk-based approach to regulating charges, allowing them to deploy their resources in an efficient, proportionate manner, in line with the BIS *Principles for Economic Regulation*. This would remove existing inconsistencies in the regulatory regime by bringing it in line with the new Water Supply Licence Regime. The aim is to remove a legislative burden on the sector and to encourage a more risk-based approach to regulation.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)
Option 1: Do nothing/status quo
Option 2: Revise the guidance from the Secretary of State on the approval of charges and introduce a licence modification to allow Ofwat to set rules for charging, which would allow a limited move to ex-post checks.
Option 3: Remove Ofwat’s function of approving charges schemes contained in section 143(6)-(9) of the Water Industry Act 1991 (WIA91) . Give Ofwat a general power to set rules for charging under WIA91, consistent with the transparent access pricing rules intended to replace the cost principle, with a risk-based approach to ensuring compliance with guidance and price limits.
Option 3 is the preferred option as regulatory costs are directly targeted at correcting non compliance and protecting customers. It also removes a barrier to developing innovative tariffs.

Will the policy be reviewed? It will be reviewed. If applicable, set review date: 09/2017					
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 Yes	Small Yes	Medium Yes	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, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: _____ Richard Benyon _____ Date: _____ 9 June 2013 _____

Summary: Analysis & Evidence

Policy Option 1

Description: Baseline option : retain annual approval function for charges schemes

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	n/a	n/a	n/a
High	n/a	n/a	n/a
Best Estimate	n/a	n/a	n/a

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

There are no monetised costs associated with this option as there is no meaningful way to assess the average costs of compliance. The water industry is made up of 22 private companies that vary significantly in their turnover, size of customer base, network and service provision. The costs companies incur in the approval process will reflect all of these factors, as well as the nature and scale of charges schemes and the extent of interaction with Ofwat.

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

- **Disproportionate/ inefficient allocation of Ofwat/water company resources.** For example, annual process costs Ofwat around £320,000 with no discretion to target resources at higher risk schemes. The current system does not provide complete assurance of compliance. Ofwat estimate the approximate cost to all water companies (there are around 22 in total) to be between £1900 and £11,250 based on tariff manager resource.
- **No flexibility to address compliance issues outside the annual approval window.** Ofwat cannot rectify non-compliance, or enforce compensation for customers that have been over-charged, until the next window.
- **Barrier to development of innovative tariffs.** In consultation, most companies argued that this drives risk-averse behaviour and constrains their willingness to offer a more sophisticated range of tariffs, such as those offered by other regulated industries (i.e. energy, telecoms or rail). In particular, there are unrealised opportunities for innovation to reflect water efficient behaviours and/or seasonal changes in availability; and to respond to recently published Government guidance on Social Tariffs designed to address affordability problems and tackle bad debt.
- **Inconsistent with recommendations of Gray Review, BIS principles of economic regulation and Water White Paper.** The inflexible and disproportionate annual approval process restricts innovation and undermines the government's objective of light-touch regulation in the water sector to incentivise greater customer focus and help meet the challenge of increased water scarcity.

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

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

It has not been possible to quantify the potential benefits of all water company charges schemes receiving equal levels of scrutiny.

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

Assurance that all water company schemes are scrutinised to ensure they meet licence conditions. In theory, this equal scrutiny of all water company charges schemes protects customers from inequitable charges and ensures schemes are compliant with licence conditions. However, in practice this assurance is illusory because Ofwat's statutory duties require them to ensure that companies can finance their functions. This places them under pressure to approve charges schemes in time for bills to be issued. Where inequalities become apparent mid-year there is not currently any flexibility to ensure that schemes are corrected and customers compensated until the next annual approval.

Key assumptions/sensitivities/risks Discount rate (%) 3.5

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	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Retain annual approval function, amend charging guidance and enable Ofwat to set charging rules in company licence conditions

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	n/a	n/a	n/a
High	n/a	n/a	n/a
Best Estimate	n/a	n/a	n/a

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

There are no monetised costs associated with this option. As above, there is significant diversity within the industry and a high level of variation in the costs companies incur in the approval process, depending on the nature and scale of charges schemes and the extent of interaction with Ofwat. It is not possible to predict the level of compliance with charges rules through a licence condition and therefore impossible to calculate the cost to companies of complying with this process. There is no evidence to suggest that the costs of this option would differ from the base case except in relation to the indirect costs of a competition commission referral (see below).

Other key non-monetised costs by 'main affected groups' This option requires an amendment to licence conditions. Each water or water and sewerage company holds an individual licence and licence changes must be negotiated on a company by company basis. A licence may only be amended with a company's consent. If a company does not consent a condition can be amended if the competition commission (CC) deem it in the public interest. There is a small potential risk that this option could only be implemented by referral to the CC. An illustrative cost of this process is £1.8M to Ofwat and companies based on Ofwat estimates.

This option would allow only a partial move to an ex-post approach to regulation. It would allow Ofwat to issue charging rules but would not remove the statutory requirement for annual approvals. As a consequence it carries similar costs to those outlined in the base option, as follows:

- **Disproportionate and inefficient allocation of Ofwat/water company resources remains.** Annual process costs Ofwat around £320,000 and the existing limitations on their discretion to target resources at higher risk schemes would remain.
- **Limited flexibility to address compliance issues outside the annual approval window.** Through this option Ofwat could address some issues through enforcing the licence condition but the majority of issues would still be deferred to annual approval process window. As schemes are still legally approved for 12 months in this option this presents a barrier to implementing in-year corrective measures.
- **Barrier to development of innovative tariffs.** Approval process remains, hence constrains water companies from developing tariffs for customers with affordability issues and to increase water efficiency.
- **Inconsistent with recommendations of the Gray Review, BIS principles of economic regulation and Water White Paper.** Annual approvals process remains, hence the limitations and barriers set out in the base case still apply.

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

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

It has not been possible to quantify the potential benefits of this option. This is because Ofwat's statutory duty to approve all schemes in order to enable companies to finance their functions counteracts any potential benefit, hence it is impossible to quantify. It is not possible to predict the extent to which regulating through a licence condition setting charging rules will bring benefits to companies as this is dependent on the nature and scale of charges schemes and the level of compliance with charges rules. It is not possible to calculate the benefit to customers of this option as it is impossible to project levels of compliance or the extent to which regulating through charges rules in a licence condition will facilitate corrective measures that may benefit customers.

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

Potential for tariff innovation: Ofwat can include rules and guidance on developing innovative tariffs through charging rules enforceable through a licence condition. However, the risk to companies of having a scheme approved annually will continue to be a barrier to such tariffs. Hence overall, impact is likely to be negligible.

Some improvement flexibility: Ofwat can use regulation of charging rules to make limited corrective measures to charges schemes throughout the year. However, they are constrained by retention of annual approval that validates all schemes.

Key assumptions/sensitivities/risks

Discount rate (%)

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 0	Benefits 0	Net: 0	Yes	OUT

Summary: Analysis & Evidence

Policy Option 3

Description: Remove annual approval function, Ofwat regulate through risk based approach on compliance with charging rules

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	n/a	n/a	n/a
High	n/a	n/a	n/a
Best Estimate	n/a	n/a	n/a

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

Overall, we do not expect any additional cost to be incurred when going from the base case to option 3. For the industry as a whole and Ofwat, the administrative cost of complying with a risk-based approach under policy option 3 is assumed to be broadly equivalent to the cost of complying with /monitoring the annual approval process under the base option. The administrative resource commitment is assumed to remain constant but better targeted.

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

Non-compliant water companies may face greater scrutiny from Ofwat under a risk-based approach. As a consequence, they may incur marginally higher but more proportionate costs. It has not been possible to monetise this indirect cost due to significant uncertainty in predicting future levels of non-compliance. This complexity is further compounded by an absence of evidence. There is also a marked variation in administrative processes adopted by companies.

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

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

There are no monetised benefits for this option due to the high degree or variability across the industry and in the complexity of the approval process depending on the nature of charges schemes. There is no clear causal link between this measure and benefits such as tariff innovation. Rather it is designed to remove a regulatory barrier that both Ofwat and the companies regard as a brake on innovation. Compliant companies are likely to achieve a small administrative saving though this is negligible and difficult to quantify. given the range of charges schemes and variability in processes.

Other key non-monetised benefits by ‘main affected groups’

The value of the potential benefits significantly outweighs costs, which we believe to be negligible. These are:

Supports a more efficient and proportionate allocation of Ofwat/water company resources. The Ofwat allocation of £320,000 will be targeted at higher risk schemes and non compliant companies enabling them to highlight and implement corrective measures to ensure customers are not over-charged. If all companies complied with charging rules this could result in an illustrative industry wide annual administrative saving of between £1900 and £11,250.

Enhances flexibility to address compliance issues outside the annual approval window. Ofwat will be able to immediately rectify non-compliance, including compensating customers for over-charging and thereby boosting incentives for water companies to comply.

Removes a significant barrier to development of innovative tariffs. In consultation 55% of water companies claim the annual approvals process is a barrier to tariff innovation. Analysis by Ofwat suggests that, in conjunction with other measures, the removal of this barrier could realise potential benefits of £25.6 million to customers in the development of social tariffs alone. Ofwat also estimate that innovative tariffs (which, for example, incentivise behaviour change in terms of water usage or reflect peaks and troughs in availability across the year) could reduce water demand by up to 10% resulting in costs savings of up to £40M per annum in reduced bills.

Significantly improves consistency with recommendations of Gray Review, BIS principles of economic regulation and Water White Paper. Enables Ofwat to adopt a light-touch, risk-based regulatory approach consistent with the Principles of Economic Regulation, Gray Review and Water White Paper.

Key assumptions/sensitivities/risks

Discount rate (%)

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as	
Costs:	0	Benefits: 0	Net: 0	Yes	OUT

Evidence Base (for summary sheets)

1. Background/Objectives

Regulation of Water Companies and the current approach to approving charging schemes

For the most part, water and sewerage services in England and Wales represent a monopoly with people generally receiving these services from one of 22 licensed regional monopoly suppliers. In the absence of competition, it is the role of the economic regulator to mimic the effects of competitive pressure on the companies. Ofwat, the regulator of the water sector, ensures that water companies charge fair prices and comply with the conditions of their licence and guaranteed service standards. One of their principle roles is to protect customers from behaviour that is discriminatory.

The framework for water charging is set out on a five year cycle through the Price Review process. Water companies develop charging schemes having regard to the parameters set out in the Price Review and with reference to charging guidance issued by Ofwat. Ofwat have a legislative duty to approve all charging schemes under section 143(6)-(9) of the Water Industry Act 1991. In exercising the power to approve charges schemes Ofwat must have regard to any relevant guidance issued by the Secretary of State or the Welsh Ministers (section 143(7) of WIA91). This applies to all charges schemes even if they are unchanged from a previous approval and/or from a water company with an excellent record of compliance with charging guidance. A company cannot bill customers until formal approval is granted. This approval is undertaken in a three month approval process on an annual basis.

Companies must submit charges schemes and compliance documentation for Ofwat to approve. This is a significant administrative burden for Ofwat and is disproportionate in that all companies are subject to the same level of scrutiny irrespective of their past record of compliance and the complexity and/or variation in their charging schemes. The approval process is concentrated in a three month period from November to February when charging schemes are submitted for approval. This process costs Ofwat around £320,000 a year. Ofwat conservatively estimates that the direct administrative industry wide cost is between £1900 and £11,250 based on the assumption that a tariff manager earning £37,500 a year requires between 3 hours and 2.5 days to complete the process. The range reflects the variability in the nature and scale of charges schemes and the required level of interaction with Ofwat to ensure approval.

The charges approved within the companies' charging schemes accounts for £9.96 billion of revenue each year (2010-11 figures). This is almost the companies' entire turnover.

The water industry is not homogenous. There are 22 water companies ranging from large water and sewerage companies, such as Thames Water, which has an annual turnover of £1,600.0 million and small water only companies, such as Cambridge Water with an annual turnover of £20 million. There are equally marked variations in the number and profile of customers served, the services that they provide; and the way in which they operate.

A small number of customers are supplied by Inset Water Companies that have a Water Supply Licence (WSL) for a limited area or site. As of December 2011 these companies only served 26,000 of the 23.8 million customers in England in Wales. These companies are subject to a lighter touch regulation. They must comply with charging guidance but charging schemes are not formally approved in the same way as licensed regional suppliers.

Ofwat have a number of powers set out in legislation that deal with charging and charging governance, including powers of determination in sections 40, 40A, 51C, 56, 66, 107, 110A, powers of determination and approval in sections 42, 99 and the power of approval in section 143. As the WSL regime continues to develop and competition and innovation in the water sector are increased as a result of implementing the market reform commitments in the Water White Paper Ofwat will need to review their regulatory approach.

In the past Ofwat have checked companies' proposed charges schemes prior to approval to make sure that they are consistent with:

- Licence condition B, which requires that overall changes in charges comply with the overall price limits
- Licence condition E, which requires that charges should not be unduly preferential or unduly discriminatory. (interpreted to mean that there should be no unnecessary cross-subsidy between different types of customer)
- Guidance on charging matters from the Secretary of State and the Welsh Assembly Government
- Duties to protect customers and to contribute to sustainable development

In this process, new charges or changes to charges and charging policy were scrutinised by assessing customer bill impacts and applying charging differential tests. Companies' charges were approved once Ofwat were satisfied that they met their requirements.

As a company cannot charge its customers until a charging scheme has been approved. Ofwat are under pressure to approve all schemes because one of its responsibilities as a regulator is to ensure that water companies are financially stable and can provide services to customers. While in theory the current process provides assurance that all charges schemes comply with Ofwat's requirements, in practice it is difficult for Ofwat to block charges or work with companies to rectify any issues within the limited approval process window. For this reason all charges schemes are approved and Ofwat are limited in their ability to ensure compliance within the time constraint of the approvals window. Given the shortcomings of this process not all compliance issues are rectified and it is difficult for Ofwat to manage the risk that non-compliant schemes will be approved. A potential consequence of this is that customers will face unfair or inequitable prices.

Once formal approval has been granted companies' charges schemes are approved for a year. If any issues are identified or complaints raised about a tariff it is problematic to rectify this within the approval year because a company can legally defend a scheme that has been formally approved. This is difficult to challenge even if a scheme is found to be in breach of a requirement or not fit for purpose. In practice this means that rectification of any such issues has to be deferred until the next approval process window. This lack of flexibility to review and rectify charging schemes within the year is a significant constraint on Ofwat in regulating the sector and protecting customers.

Limitations with the current approach

The current approach, constrained by the duty to formally approve all charges schemes, has the following limitations:

- It lacks flexibility and prevents Ofwat from adopting a proportionate approach. For example it constrains Ofwat from distinguishing between fundamental and minor issues and from taking appropriate, proportionate actions.
- The annual approval process creates a period of administrative burden for Ofwat and does not differentiate between compliance records and complexity/risk of charges schemes. This is disproportionate as it applies to all companies and all schemes irrespective of merit or levels of compliance.
- Approval is required to enable a company to charge its customers. This undermines Ofwat's ability to scrutinise and reject charges schemes as by doing so a company would be threatened by insolvency and be unable to provide services to customers.
- Approval legalises and legitimises a charging scheme for a year. This makes it very difficult for Ofwat to rectify any problems with a charging scheme within an approval year, thereby potentially limiting their ability to protect customers. Although Ofwat would have approved a scheme, as explained previously there is pressure for them to approve all schemes in order to enable companies to raise revenue to function, therefore this may mean some schemes may have unforeseen or undesirable impacts that Ofwat have to rectify.
- It is inconsistent with the recommendation of the BIS Principle of Economic Regulation of 'focus' (see section below), that Ofwat should have a range of appropriate regulatory tools at their disposal.
- The approval function is not subject to any specified safeguard for the companies if they regard the decision of Ofwat as being unreasonable, meaning that accountability of the regulator is weak. The only means of redress or challenge for companies is through judicial review.
- It is not progressive, since it allows only one decision point in each year. There is no ability to work through from incentivising to punitive regulatory responses.

- It implicitly treats all charges in a uniform manner regardless of the risks, meaning that a targeted and proportionate approach is difficult to achieve. No account is taken of, for instance, the amount/proportion of revenue a charge raises, the number of customers subject to a charge, the compliance history of the company etc.
- The approval process represents a dialogue between regulator and regulated. This leads companies to focus on complying with the needs of the regulator rather than meeting the needs of their customers.
- Companies report that charges approval is a barrier to tariff innovation as companies cannot risk a charges scheme not being approved. It also means they are unable to trial tariffs until they have been scrutinised and approved by the regulator, and they have to follow the annual process which applies to all other charges.
- The barrier to tariff innovation also constrains Ofwat in managing water demand and promoting water efficiency. It is estimated that innovative tariffs could reduce household demand by up to 10%. This would reduce household bills by approximately £2 per annum.
- It is inflexible and therefore constrains Ofwat in responding to changes and progress in the water sector.

Rationale for Intervention/Case for Change

The Government proposes to implement a charging approval process that addresses the limitations in the current approach and enables Ofwat to meet its legal duty to regulate in a way that is transparent, accountable, proportionate and targeted (section 2 (4) of the Water Industry Act 1991). The duty to approve all charges schemes, set out in section 143 of the Water Industry Act, is a significant barrier to meeting this requirement as it does not offer the flexibility to enable Ofwat to target resources in a proportionate, risk-based approach. As explained above it also limits their ability to protect customers.

It is also an example of inflexible regulation that has been highlighted for reform in several key Government strategy documents and independent reviews published in the last two years. These are set out below:

Principles of Economic Regulation

The Government reaffirmed its commitment to independent regulation in the Principles of Economic Regulation, published in April 2011. This set out a framework for effective economic regulation under the key themes of accountability, focus, predictability, coherence, adaptability and efficiency.

Under the principle of ‘focus’ it advocated that the principal objective of a regulatory approach was to protect the interests of customers, the end users of infrastructure services. In order to achieve this it advocated that “economic regulators should have adequate discretion to choose the tools that best achieve outcomes”. In this case Ofwat have recognised that the current annual approval process is burdensome to companies and is providing a barrier to tariff innovation. This is therefore a constraint on Ofwat in its objective of protecting customers because it has been explicitly cited by companies as a reason why tariffs that support customers with affordability issues have not been developed.

Under the adaptability principle it states that “the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time”. Again the current annual process for charging governance is a barrier to achieving this as it is at odds with Government’s de-regulatory policy and the vision for a more innovative water sector outlined in the Water White Paper.

Under the efficiency principle it states that “policy interventions must be proportionate and cost-effective while decision making should be timely and robust”. The current system makes this difficult to achieve as all charging schemes of all companies face the same approval process, irrespective of their content or risk or the track record of the company. This is not considered a proportionate or cost effective approach, as it does not allow resources and scrutiny to be targeted at higher risk schemes.¹

¹ <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation>)

In conclusion the current charging governance process does not conform to the best regulatory practice set out in the Principles of Economic Regulation.

The Review of Ofwat

Ofwat was recently the subject of a comprehensive independent review by Professor David Gray. This assessed performance against its key strategic priorities and duties and reviewed how effective it was in protecting customers. The Gray Review of Ofwat received 60 submissions from water companies and other interested parties during a call for evidence held between August and October 2010. Reviewing this evidence the review found 'a strong consensus of opinion that the burden imposed on the companies by Ofwat's approach to regulation is disproportionate and damaging', highlighting what was seen as a 'detailed and intrusive approach'. The review concluded that companies faced high, disproportionate costs in complying with burdensome regulation and that this had caused tensions in the relationship between companies and Ofwat. The conclusions of the Gray review mirrored the approach set out in the Government's Principles for Economic Regulation, which advocated a light touch regulatory approach across all regulated sectors.²

In response to the Review Ofwat have identified the charging governance approval process as an example of burdensome regulation that companies and Gray criticised. Ofwat have therefore highlighted charging governance as an area for urgent review and reform, with a focus on reducing regulatory burden and the costs associated with it as well as making it easier for companies to bring forward innovative, customer focused tariffs.

The Water White Paper

The Water White Paper, entitled *Water for Life*, published in December 2011, set out the government's strategic vision and objectives for the water sector. It also acknowledged and reiterated the key recommendations of both the Principles of Economic Regulation and the Gray Review to reduce regulatory burden in the sector to promote innovation and greater competition in a more customer focused water industry.

The Water White Paper acknowledged Gray's conclusion that 'Ofwat had placed too great a burden on the water companies through the way it regulates' and supported his recommendation that 'a substantial change of approach was needed to reduce the cost of regulation and drive culture change in the companies – making them less focused on the regulator and more focused on their customers.' Adopting a lighter touch, risk based approach to approving charges schemes is part of this change of approach.

The Objectives of a New Approach to Charging Governance

In order to meet the recommendations and best practice set out in the Principles of Economic Regulation and The Gray Review and support the strategic objectives for the water sector set out in the Water White Paper the Government proposes a new approach to approving charging schemes. This approach has the following objectives:

- The flexibility to target its resources at those issues carrying the largest risks or posing the most significant problems for customer protection.
- A range of regulatory responses to charging issues proportionate to the severity and urgency of the problems.
- The ability to be able to implement corrective measures and protect customers throughout an approval year rather than deferring action to the next annual approval.
- Greater company focus and accountability to the customer, listening to their needs and views in setting charges.
- Instil a culture where companies can innovate with their tariffs, especially where these are designed to meet the challenges highlighted in the White Paper, for instance, of incentivising the efficient use of water.

² <http://www.defra.gov.uk/publications/files/ofwat-review-2011.pdf>

- Flexibility to reduce the regulatory burden still further as the markets addressed in the White Paper develop.³

It is important that assurance is retained in a risk based approach to charging schemes to ensure that they comply with guidance and provide a fair deal for customers. However, removal of the duty to approve all schemes will enable Ofwat to focus resources and scrutiny on schemes that require it, therefore ensuring assurance. Low risk schemes produced by companies with an excellent compliance record require less scrutiny. Removal of the approval duty will also help incentivise the development of innovative tariffs. This can contribute towards the government's commitment to assist vulnerable customers and those with affordability problems. It can also promote greater water efficiency by incentivising more efficient water management by consumers, enable the development of more flexible, seasonal tariffs and innovative tariffs for business customers. A greater range and flexibility of tariffs is beneficial to customers and can also support the government's objectives for a more customer focused water sector that protects the environment.

A further benefit of adopting a lighter touch, risk based regulatory approach to charging schemes is that it will provide consistency with the way that Water Supply Licence (WSL) schemes are approved, therefore bringing uniformity to the regulatory approach within the sector. This will help contribute to the commitment to bring greater transparency to regulation of the water sector. It is also likely to encourage new entrants to the sector because in Martin Cave's review of innovation and competition in the water sector he highlighted high levels of regulatory burden as a barrier to new entrants. A lighter touch approach to regulation was considered an important element of attracting new entrants and driving innovation in the sector.

Based on the balance of evidence we judge that any potential risk of moving to a lighter touch regulatory approach is likely to be significantly outweighed by these benefits and largely mitigated by the proposed risk-based approach. For example, under the current system, an approval function for all schemes can be considered to give assurance of compliance to government and the public. Nevertheless, the current system doesn't offer total assurance because of the pressure on Ofwat to approve all schemes in order to enable water companies to charge customers and generate revenue. Due to this pressure (arising due to OfWAT's duty to enable companies to finance their operations) there is the risk that some non-compliant schemes are approved. A more risk-based approach mitigates against this risk in two ways; firstly transparent charges rules will provide companies with guidance on Ofwat's expectations of charges schemes and therefore reduce the likelihood of non-compliant schemes being developed. Secondly a more risk-based approach will enable Ofwat to target resources directly at compliance issues and therefore they are more likely to identify any problems and address detriment to customers. It is common practice for companies to share plans for charges schemes with Ofwat if they are unsure whether they are compliant with licence conditions, guidance or rules. In addition the move to a more risk based approach would enable Ofwat to rectify problems at any time, whereas currently they can only do so within the annual approval process.⁴

Consultation

Ofwat approached a sample of 12 companies representing a cross-section of size and geographical location, in an informal consultation on this proposed change. 11 companies responded. This represents half of the 22 water undertakers in England and Wales. 91% of respondents were in favour of the removal of a formal approvals process. This was consistent with the feedback companies provided to the Gray review on burdensome regulation. 55% thought that the removal of an annual charges approval function would increase appetite for innovation in tariffs. The remainder of the companies either stated no view on this question or said that they were not considering introducing new charges schemes due to the costs of development.

A new approach to approving charging schemes acting on recommendation of the Gray Review

³ <http://www.defra.gov.uk/environment/quality/water/legislation/whitepaper>

⁴ (<http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/interim-report.htm>)

Following Gray's recommendation for a lighter touch approach to regulation to reduce the burden on water companies and promote innovation Ofwat have implemented a Future Regulation Programme to address the issues raised in the Gray Review and act on his recommendations for reform. Ofwat's Regulatory Compliance Project has proposed a new, risk based approach to regulation which will reduce the burden on water companies. The approval of charging schemes is an important element of this project.

As a result the charging approval process has been changed. From 2012-13 Ofwat will no longer scrutinise companies' charges schemes prior to approval. Instead, each company will submit a statement of assurance to Ofwat to demonstrate that their charges comply with their legal obligations and Ofwat's charging principles. Following approval, Ofwat will then undertake risk-based checks on companies' charges to check that they comply. Appropriate action will be taken where they do not.

This process of moving to a lighter touch, risk-based approach to approval is constrained by the legislative requirement to formally approve all charging schemes. Without this legislative change both Ofwat and water companies will still face the regulatory burden of a formal approval process. Removal of the formal approval requirement is therefore necessary to complete the shift from ex-ante to ex-post regulation as recommended by Gray.

Ofwat has recently attempted to drive a targeted and proportionate approach to regulation into the approval of charges. Moving away from its historical process of scrutinising the charges schemes and principal statements, for 2012-13 charges onwards it is asking companies to give an assurance that their charges schemes comply with principles for charging which it has set out. These principles are based on the legislative requirements, current licence conditions and the Secretary of State's guidance. Ofwat will undertake checks during the year on a targeted basis. Ofwat is encouraging companies to engage customer representatives in discussion about new tariffs.

This approach is inherently limited, however, by the shortcomings of the approval process listed above. However much Ofwat attempts to introduce a targeted approach, the fact is that it must give approval at one point in the year in order for companies to charge their customers legally. It may discover problems during its subsequent checks, but correcting these will be difficult for two reasons. Firstly, Ofwat has already approved the tariffs in question, and companies can argue that the approval itself provides a defence against having to make changes. Secondly, the annual nature of the approval process means Ofwat is unlikely to be able to induce change in the problem charges before the following annual approval round. While Ofwat's intention is to allow greater scope for tariff innovation by companies, the consultation process, explained above, and feedback provided to the call for evidence in the Gray Review indicated that many companies claim that the system of approval followed by checking entails a level of risk that would not encourage such innovation.

The factors discussed above indicate that the regulatory tool of charges approval is acting as a significant barrier in enabling Ofwat to implement best regulatory practice, and fails to encourage companies to be innovative or customer focused in their charging. The proposal, therefore, is for the repeal of the provisions in section 143 of the Water Industry Act 1991 which mandate the function of Ofwat's approval of company charges schemes.

There remains, however, a need to continue to regulate companies' charges to their customers to safeguard against abuse from monopoly service providers and ensure protection for customers. It is important that the approval of charging schemes provides assurance to customers that prices are fair and reasonable and comply with Government guidance and companies licence conditions.

What is needed, therefore, is a replacement rather than simple removal. Any replacement needs to:

- Be able to be operated in a way that meets the regulatory principles (transparent, accountable, proportionate, targeted) and the BIS Principles of Economic Regulation (accountability, focus, predictability, coherence, adaptability, and efficiency),
- Allow for a shift in company orientation from Ofwat towards its customers,
- Be flexible enough not to hinder tariff innovation by companies, and
- Contain safeguards for companies so that they can challenge appropriately decisions of the regulator which they regard as unreasonable.

A rule-based system of regulation would allow this to happen. It would allow:

- Transparency by requiring the regulator to publish its rules up-front,
- Accountability by permitting the primary conversations to take place between companies and their customers,
- A proportionate approach by linking in to Ofwat's enforcement powers under Part 1 of the Water Industry Act, which provide a graduated set of tools for resolving problems, and
- A targeted approach, since it would allow the regulator to focus on high-risk issues, and to intervene and resolve those issues in a timely way as and when they arose.

Safeguards for companies could be built into this approach, for instance by requiring consultation on draft rules. Introducing a rule-based system for customer charges will require legislation, but the changes are limited, especially as provisions for a rule-based system have already been drafted in relation to Water Supply Licenses.

2. Options

We have explored three options for future charging governance:

Option 1: Base case

Under this option Ofwat will continue to keep its function of approving charges schemes contained in section 143(6)-(9) of the Water Industry Act 1991 (WIA91). All charges schemes must be approved on an annual basis prior to a water company charging its customers. In exercising its power to approve charges schemes Ofwat must have regard to any relevant guidance issued by the Secretary of State or the Welsh Ministers (section 143(7) of WIA91). They cannot use its approval power to limit the total revenues of undertakers' from charges fixed by or in accordance with charges schemes (section 143(9) of WIA91).

This assessment checks compliance with licence conditions to ensure that charging schemes comply with price limits and that they do not contain unnecessary cross-subsidy between different types of customers. Schemes must also comply with Government guidance on charging matters and the duty on Ofwat to protect customers and to contribute to sustainable development.

As part of its Future Regulation programme, in which Ofwat is acting on recommendations of the Gray Review, from 2012-13 companies will submit a statement of assurance that their charges comply with their legal obligations and Ofwat's charging principles and Ofwat will approve on this basis. Following approval, Ofwat will then undertake risk-based checks on companies' charges to check that they comply and will take appropriate action where they do not. However, they are limited in their ability to take corrective measures as charges schemes are approved for a 12 month period.

Option 2: Revise the guidance from the secretary of state on the approval of charges and introduce a licence modification to allow Ofwat to set rules on charging

The Secretary of State's guidance would be revised to support a risk-based approach to charges approval and amend expectations of scrutiny in the approval process. This would be supported by a licence modification allowing Ofwat to set rules on charging. This option would shift the emphasis from annual formal

approval to risk based enforcement through the licence of rules on charging. The legal duty to formally approve charging schemes would remain.

Changes to a company's licence can only be made with the company's consent. If a company does not consent a licence change if the case is referred to the competition commission who deem that the change is in the public's interest. An illustrative cost of referrals to the competition commission are estimated on average to be £1.8M to Ofwat and companies. This is considered a small potential risk

The key difference between this policy option and the base case is the issue of enforcement. In Ofwat's charging principles and guidelines, it has set out its expectations for companies' charges to customers. However, only the requirements set out in legislation and licence conditions B and E are enforceable. If the revised guidance and licence conditions refer to charging rules set by Ofwat, then this enables Ofwat to enforce against companies that do not comply. This will enable Ofwat to undertake risk-based checks on companies' charges and if necessary enforce companies to correct charges that do not comply with the rules. Ofwat maintain regular dialogue with all water companies to ensure compliance with licence conditions, statutory duties, guaranteed service standards and other regulatory measures. In a risk based approach to assessing charging schemes Ofwat will check that companies are complying with charging rules set out in licence conditions. If necessary companies would need to submit documentation to Ofwat on request. This would only be required if non-compliance was suspected and would be a negligible administrative burden for companies.

However, in this option the principal assessment of charges would remain the annual approval function. In most cases correction of non-compliance would be deferred until the annual approval process. This is explained further in the options assessment.

Option 3: Remove Ofwat's function of approving charges schemes contained in section 143(6)-(9) of the Water Industry Act 1991 (WIA91) . Give Ofwat a general power to set rules for charging under WIA91, consistent with the transparent access pricing rules intended to replace the cost principle, with a risk-based approach to ensuring compliance with guidance and price limits.

This option would remove the necessity for Ofwat to approve charges schemes on an annual basis. Companies would not be required to gain formal approval of charges schemes before billing customers. Companies would develop charges schemes that complied with guidance, licence conditions and charges rules. They would be able to implement these schemes and charge customers without formal approval. Ofwat would adopt a targeted, risk based approach to checking compliance giving priority to scrutiny of charges schemes considered of high risk or with the greatest potential impact on customers. If considered necessary by Ofwat this could result in non-compliant companies supplying documentation to Ofwat to verify the nature of the compliance breach. This would only be the case for companies that had not complied with charging rules. The administrative burden associated with this process is considered to be negligible and it would be proportionate. Compliant companies would not face any burden.

Under this option Ofwat would take corrective action on charges schemes found to be non-compliant. In cases where customers had been over-charged a company would be required to recompense that amount. This would only apply to companies not compliant with charging rules. It is not possible to quantify the costs this may incur on non-compliant companies as there is no way of predicting how many companies may not comply, however it is not anticipated that companies would run the risk of not complying with charging rules and facing the costs of doing so.

If this policy change were to be implemented companies would no longer be required to submit documentation to Ofwat during an annual charges approval process.

3. Options Appraisal

Costs and benefits of the reforms

The process and costs of developing and approving charges schemes

All companies incur costs in developing charges schemes and getting them approved. The main stages are tariff modelling, drafting, impact analysis and gaining board clearance. The costs vary depending on the nature and scale of the charges schemes. These costs would be incurred under all options considered in this impact assessment. The costs of approving the schemes is made up of completing a principal statement that accompanies a charges scheme, submitting the package and dealing with Ofwat challenges or requests for supporting information. Again costs will vary depending on the scale, nature and complexity of the scheme and the extent of any challenge and/or request for additional information from Ofwat. An illustrative range of an industry wide cost is between £1900 and £11,250 per annum, based on staff time required by a tariff manager. This is considered to be a conservative estimate. It is assumed that companies will incur similar costs under all options, however in the case of options where the annual approval process is removed these costs would be targeted at identifying charging issues and developing compliant schemes rather than complying with administrative processes relating to the annual approval process.

Introduction and note on how costs and benefits have been assessed

This IA does not include monetised costs or benefits for these options. This is driven by the high level of uncertainty in predicting or projecting future costs that companies may face in complying with a risk based compliance approach, which makes it difficult to reliably quantify the costs. There is a number of reasons for this uncertainty. Not least of these is the diversity of the sector. There are 22 water companies ranging from large water and sewerage companies, such as Thames Water, which has an annual turnover of £1,600.0 million and small water only companies, such as Cambridge Water with an annual turnover of £20 million. There are equally marked variations in the number and profile of customers served, the services that they provide and the way in which they operate.

Turnover by Company (Source Ofwat)

Water and Sewerage companies		Water only companies	
	Turnover £m		Turnover £m
Thames Water	1,600.0	Veolia Water Central*	241.3
United Utilities	1,506.6	South East Water	184.7
Severn Trent Water	1,372.1	Bristol Water	97.5
Anglian Water	1,079.3	South Staffs Water	84.5
Yorkshire Water	859.7	Sutton & East Surrey	53.1
Dwr Cymru (Welsh)	668.9	Sembcorp Bournemouth Water	40.4
Northumbrian Water	655.2	Portsmouth Water	35.5
Southern Water	642.1	Dee Valley Water	21.3
South West Water	444.3	Cambridge Water	20.2
Wessex Water	440.3	Veolia Water Southeast*	18.3
		Veolia Water East*	14.4

*Veolia Central, Veolia South East and Veolia Water East are under common ownership

All companies will see a slight reduction in administrative burden in the period November to February each year if the annual approval function is removed. This is considered a benefit in terms of reducing regulatory burden. Nevertheless, some companies may face equivalent costs in complying with the risk

based approach that is proposed. In this case costs would be spread throughout the year and companies would only face this burden if their charging schemes were not-compliant with Rules of Charging that will be issued to inform the process. This again highlights the uncertainty regarding the number of companies that will see any changes in costs as a result of this proposal. Nevertheless, under a more risk based approach other than completion of the compliance/principal statement costs to companies would only be incurred in cases of non compliance with charging rules. We have not been able to predict potential compliance costs because these are dependent on the nature of the charges developed and the level of compliance and scrutiny required. However, it is likely that compliant companies facing less scrutiny and administrative demands will incur marginally less costs or retain the level of costs but target them at developing compliant schemes and identifying potential issues. Ofwat currently incur costs of around £320,000 per annum in the annual approval window. This resource will be retained for all options, though in a risk based approach it would be targeted directly at non-compliance and risks to customers, thereby giving better value for money.

The benefits of these options in contributing to market reform and a greater focus on customers through incentivising innovative tariffs are covered in this section. It has not been possible to calculate the level of this benefit as this is also dependent on other factors, such as social tariff guidance. Overall the move to a lighter touch regulatory approach to charges schemes is likely to bring small efficiency benefits to companies. However, as this proposal is only one element of a suite of reforms that the Government is taking forward to meet the commitments and vision for the water sector set out in the Water White Paper it was considered that the projected benefits would not be ascribed directly to this measure. Consideration of these benefits are therefore covered in qualitative analysis.

Option 1: Base case

Under the base case Ofwat would continue to approve charges set by the companies. This involves approving a compliance statement signed by the board, as well as assessing and approving the charges laid out in the Principal Statement.

In this option companies would continue to submit charges schemes and supporting information in the three month approval process. This responsibility falls on all companies irrespective of their record of compliance or the scale and nature of the charging schemes they submit for approval. Ofwat are constrained from giving priority to scrutiny of more complex or higher risk charges schemes. This means their resources are not targeted at identifying non-compliance.

As explained in the background section this option does not give Ofwat the flexibility to address and rectify any issues with charges schemes within an approval year. If Ofwat identifies or is made aware of a charging scheme that is not compliant it is not able in the majority of cases to rectify this until the next approval window because a water company can use the defence that the charging scheme has been formally approved. In some cases this may result in Ofwat being unable to ensure that customers who are being charged too much are compensated. As this a theoretical cost it has not been monetised. However, it is an example of how the lack of flexibility in the current system is a constraint on Ofwat protecting customers.

Water companies also report in the Ofwat consultation that the current approval system acts as a barrier in introducing innovative tariffs with a focus on affordability and water efficiency. This is also restricting development of innovative seasonal and business tariffs that are more tailored to customers needs. Companies have reported that the annual approval process constrains their development of such tariffs because it does not encourage innovation. Because companies cannot charge customers unless charges schemes are approved they are very reluctant to introduce innovation due to the risk that this may risk a scheme not being approved. Therefore, the legal approval function is a constraint on companies providing more targeted, customer focused tariffs. It also restricts both when they can launch a charges schemes and its duration. For instance companies have expressed a wish to trial innovative tariffs to assess customer support. This is difficult in the current process as companies have to wait for the approval window both to launch a tariff or amend an existing tariff.

This means that if an innovative tariff was not effective it would remain in force until the next annual approval window and Ofwat would have no means of responding to criticisms or feedback. For these reasons companies have been reluctant to develop such tariffs.

Without tariffs that focus on affordability customers on low incomes will continue to struggle to pay their bills. This has an impact on all customers as the lost revenue of unpaid bills is compensated by paying customers through cross-subsidy. This has recently been calculated at an average of £15 per annum on all paying customers bills. In addition the barrier to developing social tariffs has an impact on elderly customers. Research has shown that elderly customers take pride in paying their bills, even at levels they can't afford, and in doing so cannot afford other essential services, such as heating. Therefore by removing a barrier to developing social tariffs this proposal can benefit customers.⁵ This could undermine the Government's commitment in the Water White Paper to support customers with affordability issues.

The shortcomings of the approval process are rehearsed in the case for change above.

Option 2: Licence modification and revision of guidance

Costs

There would be no extra costs incurred from complying with this policy option compared to the base case. However, implementation of this option may require referral to the competition commission to enforce the change on a company that did not consent. An illustrative value of the average cost of such a referral is estimated to be £1.8M. This is considered a small potential risk for this option.

Companies already have to have regard to charging guidance and it is not anticipated that any additional costs would be accrued in complying with charging rules arising from a licence change and revised guidance. Companies already have processes in place to ensure that charges schemes they develop are compliant with requirements of their licence and any guidance issued by Ofwat. Any costs would in any case be balanced by greater clarity on rules and expectations for charging schemes that could save a company costs in the formal approval process.

The key limitation of this option is that enforcement and approval would still be focused on the formal approval process. Although this option would provide Ofwat with an additional enforcement tool this would not have the legal weight of a formal approval under section 143 of the WIA. It is anticipated that many companies would take the legal position that the annual approval had legal precedence over enforcement of charging rules and therefore amendment/correction of many schemes would be deferred to the annual approval window. Therefore while there would be a benefit over the base case this option does not address the key limitations of the annual approval process. The burden on companies of the annual approval process, set out in the base case, would still apply.

While it mitigates to a limited degree some of the risks and barriers presented by the annual approval function the disadvantages listed in the case for change still apply.

This option would not remove the annual approvals process and therefore the barrier to tariff innovation would remain. This would limit the number of customers with affordability issues from being supported in paying their bills. It would also constrain development of tariffs to promote water efficiency.

Benefits

This option enables Ofwat to set charging rules through a licence condition against which charges schemes can be assessed. These charges rules could include guidance on developing innovative tariffs and therefore encourage companies to consider their development. However, the barrier to tariff innovation of the annual approval process would remain and companies have reported that they are unlikely to innovate unless this barrier was removed.

The benefit of this option over the base case is that it provides Ofwat with increased enforcement powers/tools within the approval year. As part of a risk based approach Ofwat will be able to identify non-compliance with charging rules and request that companies rectify the issue. In some cases this may lead to a disproportionate or unfair charging scheme to be corrected and therefore provide a benefit to customers who may receive reimbursements, if a scheme was found to be over-charging. However, Ofwat consider that in practice this would be difficult to effect if the annual approvals process remains as companies will resist any in-year changes on the basis that the schemes have been formally approved.

⁵ (<http://www.defra.gov.uk/consult/files/110405-walker-consult-condoc.pdf>)

This option could therefore contribute to maintaining and strengthening support for the most vulnerable water customers. Rules on charging could be aligned with social tariffs guidance from the Secretary of State and Welsh Ministers. This may partially mitigate the risks to companies in developing innovative tariffs, however the limitations of the annual approvals process, set out in the base case, would remain and therefore continue to be a barrier to the development of such tariffs. ICS/YouGov survey data indicates that this could bring support of up to £25.6M to customers with affordability issues. However, it should be noted that this is not an absolute benefit as this assistance would come from cross-subsidy from other customers.

Another benefit of this option is that charging rules would help shift the focus of companies from complying with regulation to identifying the needs of their customers. This would contribute to Ofwat and companies being able to target resources more effectively.

However, the benefits outlined above are limited by the retention of the approval function. As this would retain primacy over charging rules enabled by a licence modification the extent of benefits listed above is likely to be significantly reduced (see explanation under costs below).

Option 3: Function to approve charges scheme removed and given a general power to set rules

Costs

The cost changes from going from the base case scenario to option 3 are assumed to be zero. Overall the costs to companies of complying with a risk based approach are considered to be equivalent to submitting documentation for the annual approval process. Though the costs remain similar they would be more proportionate, with a risk approach targeted at schemes with a risk of non-compliance and with the largest potential impact on customers. Companies with good compliance records and settled, long term charging schemes are likely to face reduced costs as under a risk based approach they are likely to be considered low risk and therefore not be the subject of compliance checks. Companies whose schemes do not comply with charging rules, or that have a poor record of compliance, are likely to face greater scrutiny from Ofwat and therefore may face marginally more costs. This is considered proportionate with a risk based approach and necessary in ensuring customer protection.

Ofwat will re-allocate the £320,000 currently spent in the annual approvals process to a risk based approach, targeting resources directly at non-compliance and risks to customers. While this is not a cost saving it is considered that it represents greater value for money and will provide greater customer protection. This option will significantly reduce administrative burden to Ofwat during the annual approval process.

Ofwat will retain the same level of resource for all options considered in this IA, but under this option these would be targeted at higher risk charges schemes with the greatest potential impacts on customers.

Companies who implement charges that are found to be non-compliant with charging rules will face the costs of complying with requests for information and documentation from Ofwat and, if necessary, compensating customers. This is considered reasonable and proportionate. Unfair and excessive costs to customers would be identified and compensated by the companies responsible.

Benefits

This option provides all of the benefits set out for option 2 but in addition removes the constraints associated with the annual approving function. The removal of the annual approval function, identified as a disproportionate and overly prescriptive regulation and a barrier to reform in the Gray Review, would bring considerable additional benefits over option 2. This option would ensure that Ofwat complied with regulatory best practise as set out in the Principles of Economic Regulation by enabling them to adopt a proportionate, flexible regulatory approach. It would also remove an example of overly prescriptive regulation highlighted by water companies and at odds with the Government's objective of moving towards lighter-touch regulation. It also removes a barrier to implementation of the strategic vision for the water sector set out in the Water White Paper.

While it has not been possible to quantify the benefits of moving from an annual approvals process to a risk based approach any burden of costs and administration would be more targeted and proportionate under this option. This is because the focus of compliance would be on those companies and charging

schemes that present the most risk. Companies that demonstrate compliance and have an open, constructive relationship with Ofwat will face less scrutiny than those who develop inequitable or non-compliant schemes. In this way any costs incurred in complying with the risk based approach would be proportionate. There is likely to be small cost savings to compliant companies for instance in a reduction in administrative burden for existing, continuing schemes that may require less scrutiny or documentation. However, these are negligible and are impossible to quantify. Ofwat would be able to target resources directly at compliance issues. Charging rules are anticipated to bring greater clarity to the process of developing charging schemes and therefore should bring benefits of greater levels of compliance and better, more customer focused and equitable charges schemes.

In Ofwat's consultation with water companies and in further policy discussions, the charging approval function was highlighted by the majority of water companies as a barrier to developing innovative tariffs such as those offered by other regulated industries (i.e. energy, telecoms or rail). In particular there are unrealised opportunities for innovation to reflect water efficient behaviours and/or seasonal changes in availability; to offer tailored tariffs for business customers; and to respond to recently published Government guidance on Social Tariffs designed to address affordability problems and tackle bad debt. More customer responsive services and greater support for customers with affordability issues were commitments in the Water White Paper. Removal of the function can therefore be expected to contribute to the development of social tariffs as part of a suite of measures to help enable and promote these tariffs that seek to assist those with affordability problems. ICS/YouGov survey data indicates that this could bring support of up to £25.6M to customers with affordability issues. However, it should be noted that this is not an absolute benefit as this assistance would come from cross-subsidy from other customers. While this was highlighted as a benefit in option 2 it is far more likely to be a significant benefit of this option due to the removal of the annual approval function. Additionally development of social tariffs is likely to increase the number of customers on low incomes that pay their bills. In turn this will reduce the amount added to the bills of paying customers to compensate for this lost revenue. This could result in a saving of up to £15 per customer per annum. Also, this barrier to tariff innovation constrains Ofwat and the companies in incentivising companies to manage water demand and promote water efficiency. It is estimated that innovative tariffs could reduce household demand by up to 10%. This would reduce household bills by approximately £2 per annum.

The proposed approach can also bring benefits to customers who are subject to non-compliant or inequitable charges schemes. Currently the annual approvals process means that charges schemes that are found to be over-charging customers cannot be rectified until the next approvals window. This means that customers have to continue to pay unfair charges for up to a year and cannot be compensated until that time. Under the risk-based approach such issues could be identified and rectified immediately, providing increased protection for customers.

Another benefit to this option is that it will provide a more targeted approach to regulation. Removal of the regulatory burden of the annual approval process will shift the companies' focus away from their relationship with the regulator and towards their relationship with customers. It will allow Ofwat, and the companies, to target resources more effectively on those areas that are most important to customers. For example with an incentive to develop innovative tariffs by removing a barrier to doing so companies could look to incentivise efficiency measures.

We expect the benefits of this policy option of being able to have a more targeted approach would be far higher than the benefits attributed to this from policy option 2, since this option will remove the constraints of the annual approval process.

The benefits also accrue from not having to pursue regulation by approval. These include:

- Having a range of (established) regulatory tools, allowing choice of an appropriate, proportionate tool depending on the risk to water customers involved,
- Ability to take action promptly as and when action is required, rather than being tied to annual rounds
- Easier tariff innovation for companies, with potential for greater experimentation of incentivising tariffs
- A system that can be flexible and responsive to changing and developing markets.

This option would bring consistency to the regulatory approach to all water companies as it would directly align with the current approach to approving charges schemes for Water Supply Licences, who

supply large volume non-household customers. This consistency is a benefit in helping to make the water sector an attractive proposition for new investors and entrants, as it would apply a sector wide light-touch regulatory approach that was transparent and not burdensome.

This is the preferred option as it brings the most benefits and has the greatest chance of contributing to delivery of Government Objectives. It is also the only option that adequately addresses the recommendations of the Gray review and complies with the Principles of Economic Regulation. The Government is confident that the removal of an annual approval process will not remove a safeguard to customers. A targeted, risk based approach can be more effective in giving scrutiny to high risk and non-compliant schemes. Therefore the proposed option can retain assurance that prices are fair and equitable while also helping to stimulate the development of innovative tariffs that will help customers with affordability issues.

Post Implementation Review

Ofwat have a procedure in place to review the charging process after each charging round. This includes feedback both internally and externally and identifies and considers any lessons learned. This procedure will continue under the proposed system. In addition to this Ofwat and the Consumer Council for Water host workshops to review charges regulation. These have been on an annual basis and that is expected to continue. These forums will provide an opportunity to consider any complaints about the new charging process and any impact on enforcement action.

Ofwat will continue to assess charging policy and will review the process if significant problems are identified.