Utility prices: How are they calculated?

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AM Hello and welcome to the second episode of the Commons Library Podcast where our experts give you an informed and impartial take on the issues being discussed in Westminster and where you live.

I'm Andrew Mackley and today I'm joined by three policy researchers from the Science and Environment Section of the House of Commons Library: Suzanna Hinson, a specialist in energy policy; Georgina Hutton, a specialist in broadband policy; and Ed Potton who specialises in the water industry.

We're here to discuss utility prices so thank you all for being here.

EP Hello

SH Hi.

AM So now the issue of utilities, perhaps understandably, is subject to a large number of enquiries coming into the Commons Library from Members of Parliament on behalf of their constituents. These usually concern the regulation of these utilities and what this means for prices paid by everyday consumers. So in this podcast we're going to examine the water industry, which is heavily regulated, with no consumer choice and where the water companies themselves have been subject to political scrutiny. Then we'll turn to energy, which is supposed to have a competitive retail market but a price cap has only just been introduced at the beginning of this year. Finally but by no means least in this day and age, broadband where there's no regulation of consumer retail prices to allow for a competitive market.

Turning first to water with you Ed, now when paying our water bills you, or I, as consumers have to pay the one water supplier with which we're presented, without any choice, unlike our energy suppliers, for example, which we'll be discussing later. So I suppose the obvious first question is why is this?

EP Yes Andrew you're completely right, household customers have no choice in terms of their water bill. They get one bill from a single regional-based water company. Sometimes that one bill can cover different water supply and waste companies, they still just get one bill.

The background to this is that the water industry was privatised in 1989. Ownerships and names might have changed overtime but there's still just a single supplier for households – effectively a monopoly.

There have been some changes for business customers. So in 2017 just over one million business customers saw the market open. Today we're mostly talking about England and Wales, there is a different economic regulator in Scotland and Northern Ireland.

AM Right so how does this structure affect prices for the average household? I mean do different regions have different prices for example?

EP Yes different regions have different prices and these prices depend on the cost of operating, investing in the water supply and waste services in that area, similar actually to what you'll hear about energy later.

There's two parts to a water bill, the water supply and the waste element. And there's also two normal ways of being charged, either people are charged on actual usage through a water meter or through a fixed charge via historic rateable value, which is broadly based on the location and size of property.

In some areas, such as London we're seeing an increase in the number of customers that have water meters. Different prices do apply for vulnerable customers and support for these customers is part of the overall regulation process we're about to talk about.

AM Right so as I said at the outset the water industry is heavily regulated so what does regulation of these single water supplies involve exactly?

EP Well in England and Wales there's a single regulator called Ofwat, who's been set up by legislation and they regulate prices. It does that by setting a five year regulation period, currently running to 2020 and they're doing a new one at the moment called PR19 which is going to run from 2020 to 2024. Generally speaking water companies agree what they're going to deliver for customers in return for the revenues that they can expect to cover for that price review period. They do this by submitting a business plan to Ofwat based on a methodology that Ofwat have put out themselves. This determines a number of things, things like investment, leakage, customer service, incentives for the company and also revenue controls which effectively leads to a price control on the services they are providing. The companies then take on delivery against this plan, including its risks which in simple terms helps determine, amongst other things, their profitability as a company.

Looking forward to 2020 onwards Ofwat published at the end of January their initial assessment of business plans for the period 2020 to 2024. Three of them were seen as ready to implement, that is those for Severn Trent, South West Water and United

Utilities. The remaining 14 companies need to resubmit revised plans by the start of next month. The final sign off by Ofwat for all of the plans from 2020 onwards comes at the end of this year 2019.

AM So as I said at the outset and from reading around this subject, I note that the water companies have been under quite a bit of political pressure recently so I wondered how this has been affecting the process?

EP Yes there has been a political discussion about the way companies are structured and owned in England and Wales. They're all private companies so effectively they all aim to make a profit. Welsh Water is an exception to this because it's privately owned but it's actually got no shareholders and it returns its profits to the business or to its customers. Overall there's been some concern about whether this current system of regulation has really worked for consumer interests. We haven't really got time today to go into all the detail of the criticisms but what's important to note is that in the last year there has been some changes to the price review methodology and looking forward it's going to affect future regulation.

So, for example, as a result of some letters between Ofwat and the government at the start of last year Ofwat announced some regulation changes around corporate information and financing of water companies. But criticisms do continue. For example, there was a debate in Westminster Hall in January on the future of the water supply industry and the ownership options. In October last year the Environment, Food and Rural Affairs Committee called for a review of water regulation before the next price review period which will start in 2024. The water industry, for its part, argues that the current system has been really successful in supporting important investment in infrastructure.

AM Right so what can we expect to see in the long term then in terms both of pricing and regulation of these water companies?

EP Well the immediate thing customers will see will be a price increase this year. Annual price increases take place and this year the average price increase will be 2%. The average bill in England and Wales will be £415 in 2019/20. Individual price changes will vary by area and by bill type. Over the last regulation period, that is the one running to 2020, prices were due to fall by about 5% on average before inflation was taken into account, but what we see in that annual process is inflation being built into the process so actually customers have probably on average seen prices rise.

By the end of 2019 we'll also know what the requirements are for water companies over the next five years, so looking forward in the longer term. I think we can also expect to see continuing interest in exactly how that system's regulated.

AM Interesting. Thank you very much for that Ed. So turning to energy and you Suzanna we've mentioned already various differences between water and energy so I wonder if you could tell us a bit more about how specifically the energy sector differs?

SH Yes well what Ed has just been describing for water is similar to how it works for energy distribution as there are price controls for distribution and transmission companies who manage the transport of our electricity and gas, but for the retail market until recently it has been an open, competitive market where consumers are supposed to shop around for the best deal.

AM Right but it's not always worked like that has it? So how has it worked in the past and I wonder if you could tell us a bit how it's changed over time?

SH Yes so previously energy was nationalised. You got your gas from British or Scottish Gas and you got your electricity from your local area board company. In the 1980s both gas and electricity were privatised and a market emerged. Now suppliers generally supply both electricity and gas, which are obviously the same products but they do compete by offering things like different customer service, special tariffs, for example linked to low carbon energy, and importantly different prices. So until recently the number of suppliers was growing to compete for customers in this market.

AM Right so you say until recently so my obvious follow-up question to that is what happened recently?

SH Well since privatisation there has been concern that customers might be being overcharged. Customers are supposed to switch to get the best deal but a lot of customers were staying with their old regional supplier on what is known as a Standard Variable or default tariff, which tends to be more expensive. A number of reviews were conducted and eventually Ofgem, who’s the energy regulator, referred the market to the Competition and Markets Authority, the CMA. That was in 2014 so that they could assess the situation.

AM Right and has that review reported? Has it come to any conclusions?

SH Yes the review was published in 2016 and it found that most customers were still on that default, more expensive, Standard Variable tariffs and each were paying hundreds of pounds a year more than they would if they switched to the cheapest available deal. Now there are many reasons why people don't switch, for example it can be perceived as complex or a time-consuming process, especially in the case of older or more vulnerable customers who are among the least likely to switch. In total the CMA concluded that customers were paying £1.4 billion a year more than they would in a fully competitive market and they recommended a raft of measures to reform the market.

AM Right and was one of these measures the price cap, is that where that idea came from?

SH Interestingly no. The CMA recommended many things but not a full market price cap. They did recommend a pre-payment meter cap – this applies to a certain type of pay as you go meter where switching is a bit more difficult which Ofgem have put in place. And Ofgem later implemented a cap for customers that they considered to be vulnerable as they receive the Warm Homes discount. But the full price cap really only started being talked about after it was in both the Labour and Conservative manifestos for the 2017 General Election. It then appeared in the Queen's Speech, we had the Tariff Cap Act and Ofgem were required to implement a price cap.

After some consultation the cap which sets a maximum price for units of energy, came into force in January this year. The cap's supposed to be temporary and apply only until there is effective competition in the market.

AM Right so the cap is with us as of January just gone so has there been any reaction so far to its implementation?

SH Yes the cap is controversial. Some obviously welcome the end to overcharging those customers who are least engaged in the market, others think it will make the market less competitive as customers will believe that they're protected and be less likely to switch, even though switching tariffs for many people would result in higher savings than their savings under the cap. Also Ofgem review the levels of the cap twice a year and in February they announced that the price would go up which has attracted concern about the protection of customers. But on the other hand a number of energy suppliers have gone into administration since late 2018 and there is concern that the energy market is, for many reasons, increasingly becoming a challenging environment for suppliers. So the debate is likely to go on about how best to make the energy market work for everyone in future, especially as the price cap is supposed to be temporary. So the effectiveness of the energy market will continue to be closely scrutinised.

AM Thank you for that Suzanna, again something to keep an eye out for. So turning to broadband with you Georgina. As the world digitises and we become ever more dependent on the internet for a whole raft of things it's increasingly being considered as an essential utility, so how does it compare to the other two utilities we've been talking about?

GH So broadband at the moment is a bit like what Suzanna was describing about how the energy market used to be before the price cap. So in short there aren't currently any price controls on the retail prices that consumers pay for broadband. In theory there's supposed to be a competitive market of different suppliers that keeps prices low for consumers and suppliers distinguish themselves on different speeds, different prices, different customer service and things like that.

AM Okay so is there any regulation at all?

GH Yes. So like the other sectors there's a market regulator and for telecoms it's Ofcom whose role is to ensure that telecoms markets operate in the interests of consumers. And there are broadly two parts to this with broadband, one is called the wholesale regulation which essentially means regulating access to BT's network and the second is by monitoring the retail providers and making sure that they act fair for consumers.

AM Okay, so when you say regulating access to BT's network what does that mean exactly? How does that work if there's meant to be a marketplace for multiple different companies?

GH So even today in most parts of the UK broadband connections rely, at least in part, on BT's copper telephone network. So BT, or more specifically Openreach which is the physical infrastructure part of BT, owns and manages the copper telephone network and its associated infrastructure and this is a hangover from the privatisation of British Telecom in the 1980s, so before the internet was even invented. So to address this infrastructure dominance that BT has, and to provide for a competitive retail market, Ofcom requires BT to allow other companies to access its infrastructure on equal terms, to provide services, and there are some controls on the prices that BT can charge for that access and the quality of service that BT has to provide. And this in turn affects the prices that consumers pay.

AM Right. So you say most of the UK does that mean there are some exceptions?

GH Yes there are some exceptions. So one is Hull where KCOM runs the network and that's a special case, and the other exceptions are where there are other providers that provide infrastructure competition to BT. So the biggest example is Virgin Media which has its own cable network and that operates separately from BT and isn't regulated in the same way. And in the future we're likely to see a lot more of this. There are already a lot of new smaller providers that are building what's called new full fibre networks in competition to BT. So in the future the copper network is going to be increasingly less important.

AM Right, so what does all this mean then for you or me as consumers?

GH Well it means that in most parts of the UK there should be consumer choice between a few providers, even if they all rely on BT’s network. However, there is some local variation and the level of consumer choice still does depend on the infrastructure available and which retail providers are choosing to operate there. In the future we’re likely to see Ofcom moving towards more regional regulation to approach this, but in short consumers should shop around to get the best deal.

AM Well speaking of shopping around Suzanna earlier was speaking about concerns that energy customers weren’t switching their energy providers, is this also the case in broadband? I ask because I know from personal experience recently that it can be really confusing with all the different options in broadband packages, such as speed, data allowances and so on.

GH Yes as you say it can be quite confusing in broadband and there's advice on Ofcom’s and various consumer websites to try and help with this and Suzanna talked about the many different reasons why people might not switch, and in short there are concerns about consumer engagement in telecoms markets generally. So the Competition and Markets Authority raised concerns in December last year about a loyalty penalty for broadband contracts. This is where essentially longstanding customers that don't switch providers or change their contract end up paying more. And it highlighted the need for potentially further action from government and regulators to address this, especially for vulnerable consumers, again like Suzanna mentioned, people on low incomes, elderly customers, people who are less likely to switch.

AM So is Ofcom going to do anything about this?

GH This is something that Ofcom is concerned about and has been looking into, so even before the CMA looked at this Ofcom has launched a review of broadband pricing practices and has made some proposals, for example about new rules for what information broadband providers have to give you at the end of your contract, and things like that.

AM And is that going to be enough?

GH That's a good question. The CMA has suggested, and the Government also, that measures might need to go further than just giving more information, especially for vulnerable consumers, but we'll see what comes of Ofcom's pricing practices review.

AM Well thank you very much for that. We'll wait and see what happens.

So to sum up I think we can observe some common themes here such as the differences between regulating wholesale and retail markets in all three utility sectors, and while there are different degrees of regulation in each utility they've all experienced or are experiencing developments in terms of increased regulation of one kind or another which will have an impact on pricing for consumers. This is significant at a time when utility industries and the extent to which they're considered value for money are subject to ongoing debate as we've been discussing. Government, Parliament and the regulators all appear to be interested in how the sectors develop while some argue for more radical changes. So perhaps one of you could give our listeners some indication of how this debate, involving all three utilities we've been discussing today might develop over the long term. Ed?

EP Yes Andrew, these are all services that consumers need and they see all the time so I think political interest is likely to continue, both Parliament will be interested and I think the Government are going to be interested. The debate in particular is going to be informed by a regulation study that the Government have asked the National

Infrastructure Commission to undertake. They asked them towards the end of last year to look at regulation in the energy, telecoms and water industries. The Infrastructure Commission recently launched a call for evidence and the report is expected by Autumn 2019, so by the end of this year. So we can certainly expect to see more on all three industries in the future.

AM Right well we'll look to see how that turns out. And that's it for this episode of the Commons Library Podcast. For relevant briefing papers on water, energy and broadband remember to look at the episode notes published alongside the recording on our website. To keep up to date with what our researchers are working on visit commonslibrary.parliament.uk and follow us on Twitter @commonslibrary.

Next week we'll be joined by Matt Keep from the Library's Economic Policy and Statistics section to talk about the UK's public finances, specifically its deficit and its debt.

The Commons Library Podcast is a House of Commons production. The producer is Grace Rowley; the editor is Chris Blanchett; and the presenters are Andrew Mackley and Eleanor Davis. Music is by Tom Mackley.