

29 August 2008

Our Ref: DH/31/03
Your Ref:



Mandy Jones
Customer Charges Team
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

Direct Line: 01444 448375
Email: dhinton@southeastwater.co.uk

Dear Mandy,

Response to Ofwat's future strategy for customer charges for water and sewerage services: consultation

We welcome the opportunity to respond to the consultation on Ofwat's future strategy for customer charges for water and sewerage services. The document represents a useful synopsis of existing policy and potentially a significant contribution to developing new and innovative tariffs. SEW believes that significant metering is a prerequisite for the introduction of innovative tariffs, intelligent metering will also be necessary for time related tariffs such as seasonal or time of day tariffs. Therefore SEW does not believe it is likely that it is sensible to introduce company wide innovative tariffs before the start of PR14. However, the timescale of the necessary tariff trials is such that they should be started in sufficient time to provide evidence for future periodic reviews.

Although we accept that the four principles that underpin Ofwat's decisions on charges by water companies to their customers i.e. fairness and equity, affordability, incentives to consumers and companies and simplicity and transparency are appropriate we do consider that there will be occasions when they conflict and it is necessary for one of the principles to take priority. It would be useful for Ofwat to explain how they would expect these principals to be prioritized. South East Water's position on affordability as expressed within our Strategic Direction Statement 2007 is that whilst we will always consider the impact of both tariffs and investment decisions on our more vulnerable customers, affordability issues should be dealt with by central government via the benefit systems. The only real mechanism we have to provide material support to our more vulnerable customers is via a cross subsidy and customers have told us that they do not support this kind of arrangement. We also believe that most new tariffs will result in some form of cross subsidy and guidance is needed on what may be considered fair and equitable in these situations.

We welcome the encouragement of the development and trialing of innovative tariffs. However, although when we approached Ofwat about our seasonal trial at Highland Park in Ashford we felt Ofwat were very supportive, it was apparent that there was limited guidance as to the necessary regulatory issues to be agreed before a tariff trial could be commenced.

3 Church Road
Haywards Heath
West Sussex
RH16 3NY

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

We welcome the guidance included in this consultation which we believe should be more comprehensively developed in the light of actual experience of tariff trials.

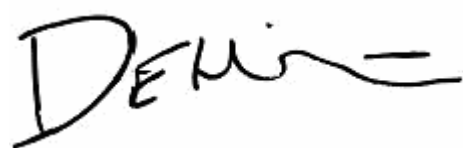
We believe that significant meter penetration should be achieved before innovative tariffs are introduced as the introduction of metering is a precedent to being able to operate new tariffs. At SEW we consider that universal metering achieving a property meter penetration of at least 80% by 2020 is supportable by sound cost benefit analysis. This is especially true when compared to the inefficient policies currently in place i.e. metering only at the request of the customer or when the property is left empty or at change of occupier.

Another consideration associated with innovative tariffs is the additional complexity introduced particularly with understanding the impact of revenue recovery. Currently as more customers are metered the annual revenue fluctuates depending on the summer weather conditions. The level of fluctuation could increase considerably with the introduction of more complex tariffs. The introduction of the proposed revenue correction mechanism provides potential protection for companies although not immediately.

We are supportive of the introduction of intelligent metering as we believe it should deliver benefits in terms of both increased usage information for the customer and reduced costs in the long term. In the former MKW area touch read meters have been installed since 1992 and the installation of radio read meters as standard was introduced in 2007. We are investigating the most appropriate delivery mechanism for our universal metering strategy and we have been analysing a number of scenarios varying such things as meter type (from a dumb meter to a fully automatic read meter), the frequency of meter read and the frequency of billing. Within this investigation we are also examining three tariff options, rising block tariff, time of day tariff and seasonal tariff. This investigation will produce the optimum strategy and will form part of our Final Water Resource Plan and Final Business Plan.

The responses to the specific questions raised in the consultation are included in the attached appendix.

Yours sincerely,



Dave Hinton
Head of Economic Regulation

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

Appendix 1 : Responses to the specific questions included in Ofwat's future strategy for customer charges for water and sewerage services.

Would you support "no change" to the current RV unmetered charging system:

- 1) under the current metering rates (shown in section 3.2 below)?*
- 2) Under a programme that delivered higher levels of metering earlier?*

Pragmatically retaining the current RV unmetered charging system is straightforward. Whilst we recognize the inadequacies of the RV approach we have not found an approach that is fairer or simpler and there seems little to be gained by switching to an alternative method.

What factors could make RV charging unsustainable and what other alternatives do you think should be considered?

There will come a point for some companies where metering has reached the maximum practical level. At this point the properties remaining unmeasured will be those that it is uneconomical to meter and will tend to be flats and other properties on shared supplies. At present customers have the option of opting for a meter and if it is not economical to install a meter an alternative assessed charge is offered to customers. This charge for SEW is related to the number of bedrooms as this acts as a surrogate for consumption. Inevitably customers will opt for an assessed charge if this results in a lower bill. If assessed charges were offered as a choice to customers who it is not possible to meter this will lead to the situation where unmeasured customers who remain on an RV based charge will only be those with a bill that is lower than the assessed charge bill. A fairer approach would be to introduce a compulsory assessed charge for customers who it is not possible to meter. This will have incidence impacts that need to be considered and managed

Do you agree with our approach to RV modifiers? If not explain the basis of your approach?

We agree with retention of the MD165 principles on RV Modifiers although we reiterate our views with regard to affordability and where responsibility for this should lie.

What are the other issues and evidence that we should consider to gain a better understanding of the costs and benefits of accelerating the uptake of metering?

Ofwat state in the consultation on page 15, *that metering could lead to less customer choice in the short term, if unmetered customers lose their right to remain without a meter and some customers would see increased bills if they are compulsorily metered.* Both these consequences are partly as a result of the unwinding of existing cross subsidies inherent with rateable value charging. Ultimately a choice has to be made between maintaining the status quo and introducing a fairer system for charging for water that reflects the volume used. Given that in the South East water is an increasingly scarce resource it seems more appropriate to introduce a charging system that enables a customer to gain some benefit for reducing their consumption.

Clearly a universal metering programme is more efficient in terms of delivery in that a systematic programme will produce economies of scale compared to the current piecemeal approach. In terms of cost and effects South East Water is modeling these considering a wide variety of impacts ranging from the impacts on revenue to the additional activity

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200

FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724

WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874

Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH

ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

required at our customer service centre. We would be happy to share our findings on this work with Ofwat once they are complete.

What are the factors which you consider should determine when universal metering becomes appropriate?

South East Water and our customers believe that metering is the fairest way to charge for water and so we believe that under all conditions universal metering is appropriate. This is even more so in areas, such as the South East, where water is scarce. It is likely that metering in the medium term will never truly pass the least cost test. However within the assessment of cost universal metering needs to be assessed against the inefficient metering policies water companies are forced to operate within currently.

Over the longer term the population will increase and climate change impacts will continue to impact on the availability of good quality raw water. It is highly likely that in the longer term due to the external factors mentioned above metering will pass the economic test but it is our strong view that we need to act now to begin changing the way our customers use water informed by increased information of their water use and controlled by the use of new tariffs.

How should metered standing charges ideally be constructed to accurately reflect the customer and volume-driven costs while also enabling competition?

The current approach to metered standing charges aims to recover the cost of installing and maintaining the meter and meter pit along with the operating cost of obtaining the meter read, sending the bill and customer account costs. This results in both the recovery of costs in a cost reflective manner and could potentially encourage competition if accounting separation of the retail services is introduced.

In terms of appropriate pricing signals the volume driven costs should not be recovered through the meter standing charge.

To what extent have these issues been explored by companies up to now and what evidence is there that could be taken into account when assessing options?

SEW are carrying out a tariff trial of a seasonal tariff on a new household development at Highland Park in Ashford. This development will have 250 properties when complete, a 100 of which will be on the seasonal tariff. Currently 147 properties have been completed and 32 are on the seasonal tariff. At present insufficient data regarding the impact of the seasonal tariff has been collected in order to assist with future tariff decisions.

What are the issues involved in setting up and running successful tariff trials as a way to obtain sound and timely information in support of new household tariff trials?

The experience of commencing a tariff trial at Highland Park has identified the following issues:

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

The data capture of monthly consumption has required the development of additional computer systems as it was not economic to adapt the existing billing system. Also the development and production of invoices for customers on the tariff trial has resulted in separate invoicing procedures being required as it was not economically feasible to adapt the water billing system to produce invoices for customers on the tariff trial.

Using a new housing development for a tariff trial has enabled the Company to investigate the impact of water efficient fittings by being involved in the choice of water efficient fittings such as shower heads, cisterns and taps without requiring all the problems associated with retrofit. However the downside of using a new housing development is that it will take around three years before all the properties are built. This inevitably means that it is going to be a number of years before the tariff trial is able to produce useful information.

A seasonal tariff was considered appropriate for this tariff trial because the constraint on resources for Ashford is peak demand and the purpose of the investigation is to examine whether or not higher summer tariffs will influence customers demand. The volumetric tariff in 2008/9 for the September to April period has been set at £0.48 with a tariff of £1.88 for the May to August period. This compares to a standard volumetric tariff of £1.00. These tariffs were set to give a meaningful differential between the summer and winter rates and to have a neutral effect on a customer with an average summer / winter ratio of demand.

Ideally the trial would test a range of tariff levels. However it was not considered practical to run the trial with more than one tariff option as this would complicate the communication process. An option that has been considered is to adjust the mix of tariffs in future years. This would result in the need to run the tariffs over a relatively long period, maybe six years as it is probably necessary to run each tariff combination for a minimum of two years so the impact of the tariff can be tested over a range of summer conditions. Tariff trials do need to be run over extended periods particularly when assessing tariffs on a seasonal basis. The added complication is that over the last three years it has not been possible to treat any of these years as a "normal" year and climate change may make this an ever increasing issue.

A decision was made that the tariff trial will be imposed on customers compulsorily. The control properties with standard tariffs and those who would be on the seasonal tariff has been agreed with the developer informing customers buying new properties about the tariff trial. This decision was taken because it was considered that if any choice was given to customers the results of the trial could be compromised.

Are there incentives that could be offered to companies to share the results of robust early trials?

There is generally good information sharing within the Water Industry both through formal projects run by UKWIR and informally through contacts between companies and the regulators. The involvement of both Ofwat and the EA on UKWIR projects has been established as an effective means of sharing information with the regulators.

There is a financial cost to running tariff trials. It is probably appropriate that specific funding is allowed as part of the supply / demand capital at PR09. An appropriate output would be a report on the trial that would be made available to the regulators and other companies

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

What are the issues each company must take into account when assessing whether to impose a tariff or offer it as an option? Where should the balance lie in offering innovative tariffs and protecting customers who are not on those tariffs?

Generally we believe it will not be appropriate to introduce new tariffs that have demand management objectives on an optional basis as this would result in customers selecting the tariff that would be economically advantageous regardless of the objectives of the tariff. We also believe that the introduction of innovative tariffs that will inevitably be based on measured volumes require universal metering to have been achieved to a significant level.

Currently customers who can not be economically metered are offered the choice of staying on an unmeasured rateable value charge or an assessed charge. For SEW the assessed charge is based on the number of bedrooms which is a surrogate measure for demand. Currently as metering is optional for customers and reversion is possible within 12 months the assessed charges are also optional. Given that practical universal metering is only going to be achieved through compulsion it would seem consistent for properties where it is not practical to meter that assessed charges would be more appropriate than rateable value charges and should be introduced compulsorily.

What other types of optional tariffs could be developed, beyond those considered in this consultation, and what might their impact be (for example interruptible tariffs for large users)? How do they meet the objectives we have set out for the development of future tariffs and charges?

We believe that it is appropriate to consider tariffs that will incentivise customers to reduce their water usage in a manner that benefits both the customer and the environment. This could include interruptible tariffs possibly associated with an incentive to promote greater on site storage by commercial customers who do not need water for domestic purposes. However although we have considered this type of tariff conceptually, we have yet to successfully identify a large user customer to whom it would be effective to provide such a tariff option.

How far do we need to regulate the level of charges set under optional tariffs so long as other customers continue to be protected?

It is reasonable to expect that the annual Principal Statement process continues so that the overall price increase is confirmed to be within price limits. It is also important that tariffs for all customer classes are perceived to be fair and do not discriminate against certain groups of customers.

Companies will be expected to achieve least cost business plans for their customers that result in tariffs that achieve overall cost recovery. It is not reasonable to expect companies to set social and affordability guidelines.

One of the largest issues relating to the development of new tariffs is that in most cases an element of cross subsidy will be created. To give an example the rising block tariff typically uses an assessment of water needed for hygiene and health purposes on a per head basis. The fairest way therefore to set the hygiene and health level for a property is to multiply the individual allowance by the number of occupants in each property. However, companies do not hold reliable individual property occupancy levels and nor is it appropriate or cost

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People

effective for them to do so. Companies will therefore need to select an occupancy rate which, for illustration, might be set at 4. This will mean that properties with less than 4 occupants will have a larger hygiene allowance per head and those with more than 4 will have less of an allowance. This is the classic cross subsidy issue and will likely occur in some form or another in any new tariff. Therefore Ofwat should continue to have a role in approving tariffs which will include the introduction of new tariffs or changes to the structure of tariffs. It is important that companies can understand the likely response from Ofwat to their innovations. This can be achieved through the publication of tariff principles (particularly around the definition of “undue discrimination”), publication of tariffs, precedents and company meetings.

How should non-potable charges fit with the principles of geographically averaged charging whilst taking into consideration the potential differential use of specific water supply functions (i.e. possibly more limited use of service reservoirs, pumping, distribution etc)?

Non potable water will only use a limited part of the company’s system and the charges for non-potable water should reflect this.

**3 Church Road
Haywards Heath
West Sussex
RH16 3NY**

TELEPHONE
01444 448200
FACSIMILE
01444 413200

EMERGENCY LINE
0845 602 1724
WEBSITE
www.southeastwater.co.uk

South East Water Ltd
Registered in England No. 2679874
Registered Office: Rocfort Road, Snodland, Kent,
ME6 5AH
ISO 9001 Certified
ISO 14001 Certified
IHSAS 18001 Certified
South East Water is an Investor in People