

Our Ref: AJDF/JC/Ofwat

Your Ref:

23 November 2012



Mr Keith Mason  
Director of Finance and Regulation  
Ofwat  
City Centre Tower  
7 Hill Street  
Birmingham  
B5 4UA

Sutton and East Surrey Water plc  
London Road  
Redhill  
Surrey RH1 1LJ  
Telephone 01737 772000  
Facsimile 01737 766807  
Website [www.waterplc.com](http://www.waterplc.com)  
Email [sesw@waterplc.com](mailto:sesw@waterplc.com)

Dear Keith

**NOTICE UNDER SECTION 13 OF THE WATER INDUSTRY ACT 1991:  
"CONSULTATION ON OFWAT'S SECTION 13 PROPOSALS TO MODIFY COMPANY  
LICENCES: 26 OCTOBER 2012**

This letter comprises the formal response of Sutton and East Surrey Water plc to the above Notice.

After full and careful consideration of the modifications to the Company's Instrument of Appointment proposed by the Notice, and having taken advice, the Board of the Company has decided not to consent to the modifications. It would, however, be prepared to consider more focused and proportionate changes necessary to implement the structure and form of price limits envisaged for the next Periodic Review (PR14).

In this context, we consider the clarifications you published on 20 November helpful as an indication of the way in which we might - without an unnecessary, distracting and expensive referral to the Competition Commission - continue to seek to develop proposals that meet our common objectives of allowing the regulatory regime to evolve in step with the crystallisation of Government policy whilst maintaining the investor confidence that has been and will remain crucial to securing investment at the lowest possible cost to customers. However, the highly qualified nature of the 'Principles and criteria for new forms of control' in the clarifications paper only add to the concerns set out below, that overall the proposals will have an adverse impact on investor confidence by increasing the level of uncertainty in how new price controls will be operated.

The rest of this letter sets out our formal grounds for rejecting the proposed modifications as drafted - in line with our obligations under the Section 13 Notice - before returning to our offer to seek to agree the more limited changes needed to implement agreed Government policy as reflected in the proposed methodology for the next Periodic Review.

We set out below a summary of the reasons for this decision which we invite you to consider pursuant to your statutory obligation to consider representations and objections made in response to the modifications under Section 13(2) of the Water Industry Act.



## Representations and Objections

Our understanding is that the rationale for the modifications is principally twofold:

- a) to enable Ofwat to set separate wholesale and retail prices at PR14:
- b) to support the reforms envisaged in the Water White Paper and Draft Water Bill.

We will comment on each of these separately below.

### a) To enable Ofwat to set separate wholesale and retail prices at PR14:

The Company has no objection in principle to Ofwat being able to set separate wholesale and retail prices at PR14. However, the modifications go substantially further than permitting such separation and give Ofwat wide powers:

- (i) to move services and activities out of wholesale control at both a price determination and during a price control period (albeit subject to a cumulative ceiling of 40% of revenue);
- (ii) to redefine the boundaries between wholesale and retail activities;
- (iii) to set whatever time periods it wishes for the duration of its various price controls after 2019; and
- (iv) to move activities between controls in certain circumstances without any entitlement for the Company to appeal any such move to the CC.

Limitations on these new powers of specified percentages of revenue and the ability of the Company in some, but not all circumstances, to take any objections to the Competition Commission, are considered to be wholly unsatisfactory. Furthermore using industry parameters for these percentages unfairly penalises the water only companies.

We consider that the degree of flexibility contained in the modifications allowing Ofwat to set separate retail and wholesale controls go beyond what is necessary to achieve that objective.

We acknowledge that the Government accepts that Ofwat's proposal to set separate price caps for retail and wholesale activities is a decision for it to take as independent economic regulator. However, the Government has also stated that Ofwat should give particular consideration to the potential impacts on investment in the sector, including the impact on investor confidence in the regulatory framework. It is our view that the degree of flexibility sought by Ofwat in its modifications will have an adverse impact on investor confidence in the industry by increasing the level of uncertainty in how price controls will be operated, which will in turn increase the level of risk associated with investment in the industry and therefore the cost of such investment.

Further, although the Government has indicated that where proposed changes to the regulatory framework by Ofwat are sufficiently substantial, Ofwat is expected to provide a thorough assessment of the impact of its proposals on both consumers and investors, including evidence of the cost and benefits, Ofwat has failed to provide such a statement in the present case on the basis that, it does not consider this is required as the modifications will "not in themselves change the way that price controls are set: they merely give us the option to set controls in different forms in future".

This justification for not supplying an impact assessment is not accepted and we believe that it should have been provided to enable the Company to consider the impact prior to being asked to consent to the modifications.

b) To support the reforms envisaged in the Water White Paper and Draft Water Bill

With regard to this justification, we would make two points:

First the reforms are:

- not yet law;
- are contained in a Bill which may well be amended in its gradual passage through Parliament;
- if and when they become law, in whatever form that ultimately takes, they are unlikely to take effect before 2017 (the Bill is expected to receive Royal Assent some time in 2014 and the recommendation of the House of Commons Environment Food and Rural Affairs Committee was that "Defra opens the retail market three years from Royal Assent to a Water Act").

Second, the Draft Water Bill contains a specific provision (Section 23) granting powers to Ofwat to modify company licences "where it considers it necessary or expedient to do so in consequence of amendments made to the [Water Industry Act 1991]" made by the provisions of the Bill.

In the light of the above, we consider that the proposed changes are:

- (i) premature, as the relevant legislation is not yet enacted and may well be amended as it passes through Parliament;
- (ii) unnecessary as Ofwat will, subject to parliamentary consent, be given the powers it needs to amend companies' licences in consequence of the legislation, in that legislation.

## **Summary**

The White Paper has stressed the importance of stability to the industry and the Government has acknowledged the value of the RCV funding model for infrastructure investments. In these circumstances, we see incremental change, backed on each occasion by evidence of the benefits of the change before the next step is taken, as being the best way forward. In the absence of clear benefits for the current proposals, we have difficulty in accepting that the greater degree of risk in terms of higher funding costs which we believe the proposals will entail, and thus adverse effects on customers, is a risk worth incurring or is compatible with the public interest.

We are more than happy to continue discussions on the elements of the licence that need to be changed for PR14 and any alternative proposals Ofwat may develop so we can find a way forward that will avoid a referral to the Competition Commission. In order to demonstrate the feasibility of amending the licence for PR14, the industry has worked together with its advisers to develop an alternative set of modifications to Condition B. Agreeing to any such alternative proposals would in no way restrict Ofwat from making

further proposals in future but would avoid a Competition Commission inquiry which we know would be a major resource challenge and distraction for all parties involved.

Yours sincerely

A handwritten signature in black ink that reads "Anthony Ferrar". The signature is written in a cursive style with a large, sweeping initial 'A'.

Anthony Ferrar  
Managing Director