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Our ref:

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Dear Keith,

Section 13 proposals by Ofwat to modify company Licences

I refer to your letter dated 26 October 2012 and the consultation document published on that same date containing proposals under section 13 of the Water Industry Act 1991 to modify Conditions B and C of companies' Licences (the "Consultation").

The South West Water Board has reviewed in detail the published proposals. Underpinning the Board's deliberations has been the consideration of what is in the interests of all our stakeholders in discharging the responsibilities and obligations of our Licence. We have necessarily focused on what is in the best interest of our customers now and in the future.

Working towards the vision of a more efficient, innovative and customer-focused water industry, the Board recognises the policy intentions outlined in the UK Government's Water White Paper. These objectives are underlined by a strong emphasis on the need for change to be evolutionary in nature and balanced carefully to maintain a regulatory environment that is attractive to investors.

Defra's recently published consultative Strategic Policy Statement to Ofwat outlines the Government's aim for an innovative water sector operating within a transparent and predictable regulatory regime. In particular, we note that where reform to the regulatory framework is required it should:

- not anticipate or pre-empt Government policy decisions
- be based on a thorough assessment of the impact of the proposals
- not introduce unnecessary uncertainty
- reflect the boundaries set by Government and not prejudice decisions about the future direction of policy.

Whilst accepting that there is a long term timetable for reform, the Board considers the scale of the S13 proposals to be both premature in the context of a *draft* Water Bill and contrary to the principle of evolutionary change. The proposals indicate activities representing c.50% of revenues from an average water company value chain may be moved out of a return based RPI+/-K price control. The Board considers that the proposed package of modifications contained in the Consultation amount to a very substantial change to the existing regulatory framework for price control, which has served companies and their customers well over many years and has provided a demonstrably stable basis for the huge investment needed to sustain the provision of high quality water and sewerage services in a changing environment.

Consistent with the principles set out in Defra's consultative draft Strategic Policy Statement to Ofwat, the Board believes that Ofwat needs to demonstrate that it has given particular consideration to the potential impact of its proposed changes on investment in the sector, including the impact on investor confidence in the regulatory framework, and that Ofwat should provide a formal impact assessment of its proposals on both customers and investors, including evidence of the costs and benefits.

Uncertainty exists as there are naturally a number of unknown variables when considering a longer time frame (the Water Bill is still a '*draft* Bill'). We can not conclude that the proposed Licence changes address what will be necessary to support legislation arising from a Water Bill.

Uncertainty manifests itself in adverse investor sentiment (as witnessed by listed water company share price movements since the publication of the S13 proposal, and Rating Agency publications). The Board believes it is essential to minimise this uncertainty which has a material impact on the business and ultimately customers. Given that the impact of future change is not yet clear, the Board cannot reconcile the degree of flexibility that Ofwat is seeking to incorporate into the Licences now with the need to maintain investor confidence for the benefit of customers.

In addition to these overarching points of principle, we have concerns about a number of aspects of the specific drafting that Ofwat has proposed in its consultation. Whilst the South West Water Board welcomes Ofwat's commitment to retaining a linkage to RPI in respect of wholesale price controls at this time, there are concerns about:

- the absence of a more comprehensive definition for both retail and wholesale activities within the terms of the Licence which would allow for a clear understanding at the outset of what was attributable to each
- the extent of the "flexibility" sought by Ofwat to move activities out of wholesale
- the lack of scope for review or challenge within the draft Licence of any proposal by Ofwat to transfer activities from one price control to any other price control during the course of a price review period other than when this coincides with a new price control determination
- the absence of any point of reference for "K" in the proposed draft Conditions in paragraph 8.4.
- the possibility set out in the proposed Conditions for price controls to be fixed by reference to *costs* or revenues
- the setting of the Materiality Ratio at a level where Ofwat could still designate a very significant proportion of revenues as not benefiting from protection by way of links to RPI
- the absence of any express link to RPI in respect of non-contestable retail activities in the proposed Conditions

- the absence of limitations in the proposed Conditions on the number of price controls which may be in place at any one time
- the apparent lack of an ability in the proposed Conditions to challenge individual price controls or elements of price controls rather than what Ofwat regards as the entirety of a determination.

After much consideration, the Board does not believe the Licence modifications as set out in the notice are in the best interests of our customers and under the circumstances we are unable to consent to the modifications as set out in the section 13 Notice.

It is evident, however, when looking at Government's draft timetables for reform, that the current Licences may need to evolve to facilitate the introduction of retail competition for business customers' post 2017.

To this end we have been working through the trade association Water UK to prepare an alternative set of suggested draft Licence modifications which seek to address our concerns in a manner consistent with Ofwat's principal stated aim of introducing separate retail and wholesale price limits, and in time for PR14.

Our main purpose in preparing an alternative draft is to help inform further discussions with Ofwat and thereby expedite an agreed outcome. In the time available it has not been possible to finalise the drafting and we recognise that there are a number of aspects on which further work needs to be done, but we would welcome sharing the latest draft with you in the interest of taking matters forward constructively.

Whilst we believe the Licence modifications in the S13 Notice are not necessary at this time, we do believe that pragmatically there is common ground to agree Licence changes to facilitate reform.

We are keen to engage with Ofwat with a view to finding a mutually acceptable way of addressing our concerns satisfactorily and thereby avoiding the need for a referral to the Competition Commission. The South West Water Chief Executive has written separately to the Ofwat Chairman on this matter.

We are cognisant that continuing uncertainty about the outcome of proposals to change the price control framework is itself having an adverse effect on investor confidence. We are therefore committed to trying to resolve matters with Ofwat as quickly as practicable. We shall therefore be happy to make all relevant personnel at South West Water available to meet and progress discussions with Ofwat at your convenience.

Yours sincerely



Susan Davy
Finance & Regulatory Director