



Stephen Beddoes  
Finance and Networks Division  
Ofwat,  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Head Office  
Inveralmond House  
200 Dunkeld Road  
Perth  
PH1 3AQ

Telephone: 01738 456401

Our Reference:

Your Reference:

email: aileen.boyd@sse.com

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Dear Stephen

### **Setting price controls for 2015-20 Consultation on framework and approach**

SSE Water is a new appointee that has been serving customers within a growing portfolio of new “inset” housing developments since 2007. Its initial customers are housing developers who are able to make a choice between dealing with the incumbent water company for the water infrastructure they need and working with a new entrant. If they choose to work with a new entrant, Ofwat’s new appointments and variations (NAV) application process is followed and, in the normal course of events, the new entrant becomes appointed as the relevant water company for the development concerned as part of that process.

NAV appointees are currently required by their licences to set retail prices at or below the level of the existing appointees in the areas they serve – a form of “relative price control”. This obligation is confirmed and maintained through Ofwat’s annual assurance process for the approval of Charges Schemes. As such, SSE Water has not been involved in the detail of the full price control setting process for incumbents. However, the prospective developments in the current price control process – particularly those associated with the separate definitions of wholesale and retail activities – are likely to affect the commercial framework for SSE Water’s business model going forward. We are therefore interested in price control developments and have provided below comments and responses to some of the consultation questions under various headings from the consultation paper.

#### Defining retail and wholesale services

*Q4 Do you agree with our definition of retail? Specifically, do you agree with our preferred option for demand-side water efficiency services, customer-side leaks and developer services?*

We are happy with the groupings within the retail and wholesale definitions, and the use of the ‘by exception’ approach to defining wholesale, whereby any activity not included in the



'retail' definition is automatically part of 'wholesale' unless explicitly excluded in the licence. We recognise that there may be a range of services provided to NAV appointees as customers of the incumbent wholesale businesses that are not explicitly set out in the consultation and that greater clarity on these may develop over time.

#### Controlling wholesale revenues

We note with some concern the introduction of additional flexibility for incumbent water companies in setting wholesale charges, as these are a very important commercial input to our NAV appointee business. In our view, additional flexibility should be accompanied by safeguards, for the market as a whole, on the transparency and non-discrimination of those wholesale charges. A sentence in section 4.3.1 notes that:

*“Companies may be required to publish their wholesale charges, in addition to the existing legal requirement for them to publish a retail charges scheme”*

To allow new entrants into the market and to allow competition to develop and bring benefits within the industry, we believe it is very important for wholesale bulk tariffs to be established and for these to be published, transparent and reasonably predictable from year to year. In the absence of clear and publicly available data on the wholesale tariffs applicable to a new appointee, it would not be possible for any potential new entrants to assess properly the viability of potential inset sites or an overall business case for market entry. We would therefore urge Ofwat to be clear that publication of wholesale charges “will be required”.

It is also important that wholesale charges are non-discriminatory between the downstream business of the incumbent water companies and inset appointees or other types of new entrant. To enable fair competition, it is axiomatic that there should be a 'level playing field' and that NAV appointees do not face higher upstream costs – including those forming part of one-off connection charges – on a like-for-like basis than the competing part of the downstream incumbent business for the development in question.

Another sentence in section 4.3.1 states “... *companies may be required to demonstrate that [their] wholesale charges will recover no more than their allowed wholesale revenues.*”

We consider that, particularly in the early days of a new revenue-based control, it will be essential for Ofwat to require proof that companies are setting their wholesale charges to recover no more than their projected allowable revenue and even to obtain an audit opinion on the reasonableness of the charge setting models and assumptions used. In the early stages of the new market arrangements, it will be vital that all market participants have assurance, through Ofwat, that wholesale prices are set on a reasonable basis with no targeting of increases at particular groups of wholesale customer/competitors.

It would also be reassuring to new entrants and existing competitors if incumbent water companies were required to produce and abide by approved statements describing how their wholesale commodity and connection charges are to be set and varied from year to year. This form of transparency has developed in the regulatory framework for energy network wholesale charges: in particular, publication of changes to annual wholesale 'use of system' charges is required some months in advance of their coming into force.



In similar vein, we suggest that transitional arrangements to smooth changes in prices may be appropriate if, as a result of greater clarity on costs, there are to be significant changes in any element of incumbent wholesale or retail charges. The intention of such transitional arrangements would be to smooth the impact of changes in pricing structure on retail customers and competitors through use of a glide path that, for example, limits the percentage change in any element of the structure of charges in a financial year.

We believe that consideration of such pragmatic commercial matters is necessary to support the efficient entry of new entrants to the market; the efficient use and development of water resources; and the efficient delivery of services to end customers.

Retail controls for non-household customers

*Q23 Do you agree with our preferred option of rolling over existing tariff structures to form default tariffs?*

In our view there are a number of aspects of existing water retail tariff structures that reflect legacy factors, which may no longer be relevant to today's circumstances. There is also significant variation in the tariff structures offered by different incumbent water companies. We therefore feel that it may now be an appropriate time for the industry to properly review existing tariff structures – both retail non-household tariffs and the separate wholesale tariffs – to ensure that they remain appropriate and fit for purpose as greater separation and competition is introduced into the market.

*Q29 Do you agree with our preferred option of setting the default tariff minimum service level using the existing GSS standards?*

Yes we agree with the intention to base minimum service levels on existing GSS standards.

I hope these comments are helpful as Ofwat develops its approach to the price control setting process. Please let us know if you would like to discuss any of these points further. We look forward to understanding how the new price control arrangements and obligations on incumbent water companies will interact with the reforms proposed in the draft Water Bill to enhance the framework for competition from NAV appointees and other new entrants to the water market.

Yours sincerely

Aileen Boyd  
Regulation Manager