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Dear Ynon

Consultation on charges scheme rules for 2016-17 and future developments

SSE has a subsidiary company - SSE Water Limited (SSE Water) - that participates in the water markets under the New Appointments and Variations (NAV) framework and is sometimes known as a "new appointee". We welcome the consultation on the above topic and set out some comments below, with responses on some of the specific consultation questions set out in the appendix to this letter.

Retail Charge Setting

Over the years, new appointees and other 'small companies' have had a different set of requirements to follow for the annual charge setting process, compared with incumbent water companies. This is because, through the 'relative price control' requirements in Condition B of the NAV licences, a new appointee's retail prices are restricted to be no greater than the equivalent retail prices of the incumbent(s) in whose areas the new appointee's area lies rather than being derived directly from a price controlled revenue allowance. In developing a single set of rules for retail charge setting processes, it is still necessary for these to take into account the fact that new appointees are dependent on incumbent water company charging information and need to have sight of the relevant incumbent charges before they can finalise their own charges.

Developments in Wholesale Charges

In section 4 of the consultation, future developments in wholesale charging and other charging rules are considered. We welcome this, as rules on wholesale charges are very important for SSE Water as a new appointee. For reference, we describe the business model of new appointees below, before making some observations on the topics covered in this section of the consultation.

A new appointee provides and maintains local water and/or sewerage infrastructure at one or more appointed areas, which previously fell within the geographic area of incumbent water companies. As discussed above, its retail prices are capped in its licence to be no more than

the host incumbent water company's equivalent retail tariffs and this includes retail prices for any non household customers within its appointed area. Wholesale charges are typically set by incumbent water companies via bulk supply agreements with new appointees and it can be seen that the level of these are critical in determining the viability and profitability of new appointee areas.

With the introduction of retail competition for non household customers in 2017, incumbent water companies will be required to set wholesale charges for retail licensees based on their separate wholesale price controls. Where new appointees have non household retail customers in their appointed areas, they will also have to set wholesale charges for retailers but, by analogy with the retail charge setting process, will have to have sight of the relevant incumbent wholesale charges before being able to set their own equivalent wholesale charges for retailers. In order for new appointee wholesale charges to approximate to the wholesale charges for retailers set by the incumbent, it will be necessary for the wholesale charge set by the incumbent to the new appointee to be set lower than this, in order to preserve a margin for the new appointee and to reflect the fact that it provides the service of local infrastructure provision and maintenance: downstream from the incumbent water company boundary but upstream of the retail licensee. Thus, there are potentially issues in both wholesale charge levels and timings for new appointees and we propose that these are specifically addressed in Ofwat's developing guidance on wholesale charge setting.

Against this background, we have the following additional comments on points made in section 4.

1. If new appointees are to be required to publish 2016-17 wholesale charges in January 2016, they will require sight of incumbent wholesale charges earlier than this or else be able to publish their wholesale charges somewhat later. The same reasoning would apply to any future requirement to publish indicative wholesale charges at specific earlier points in the charging year.
2. Footnote 8 on page 22 states that wholesale charges scheme will not cover charges "outside the non household retail market, such as bulk supplies of water from one company to another". Since wholesale charges to new appointees are part of the supply chain into the non household retail market, as discussed above, we would like to see this statement clarified to ensure that wholesale charges schemes do include wholesale charges for new appointees.
3. Following on from the above point, we believe that a distinction should be drawn between inter water company bulk charges for upstream purposes, such as balancing water availability or trading and the bulk supply charges that feed into the supply chain for retail markets. In order for the non household retail market to work smoothly in situations where non household customers are situated in a new appointee's area, we believe that Ofwat will have to specify rules to govern the bulk (wholesale) charges from incumbents to new appointees in the latter situation, as part of its work on wholesale charges prior to market opening.
4. The new licences supported by the Water Act 2014 include wholesale authorisations, whereby water can be introduced to the supply systems of undertakers, which appear to mirror the intention behind the current combined licences. It therefore appears that charging rules will have to be developed to cover the various situations covered in that Act, including for the transportation of water between different points on a water supply

system. This is not mentioned specifically in section 4 but presumably wholesale or 'access' charges for these situations will need to be set out by incumbents for the benefit of wholesale licensees. These type of access charges would also be of interest to new appointees, who may also wish to investigate the potential to source bulk water from water companies other than their 'host' incumbents; and so it would be helpful if any charging rules on this topic did not restrict the availability of such wholesale services and charges only to water licensees.

5. When Ofwat collects information annually on special agreements from appointed water companies, this includes information on bulk supply agreements, although we are not clear whether these are formally special agreements under s142. We note that section 4.1.3 sets out arrangements that Ofwat is minded to put in place to allow licensees a margin if they choose to serve non household customers who currently have special agreements with water companies and would highlight that new appointees also need to be allowed a margin – in this case, between input wholesale charges from incumbents and both wholesale charges to licensees and retail non household charges in their area.
6. New appointees have a particular interest in the prospect of charging rules for developer services, as discussed in section 4.2. Developers are the initial customer who can choose to place business with a new appointee's competitive bid to provide local infrastructure rather than requisition that infrastructure from the incumbent water company. We share the concern about lack of transparency in these charges and would go as far as to state that new appointees are not being treated in the same way, with respect to offsite reinforcement work, as developers requisitioning a supply under the statutory framework.

On this topic, we would like to see the charging rules that Ofwat expects to be developing later in the year move the industry towards the prevailing position in the energy industry: that charges relating to a particular type of connection do not vary depending on who is asking for the connection i.e. 'any person' is entitled to be given information on the cost of connecting a local development to the same timescales and at the same cost as any other person making that same enquiry. This would do much to ensure a level playing field between competitive providers of local water and sewerage infrastructure and incumbent water companies.

Conclusion

New appointees are 'upstream' of pure retailing activity and need support in the developing charging rules and frameworks for market interactions in a similar manner to new retailing licensees. In particular, the level of wholesale charges to new appointees from incumbents is crucially important to this model of competition and we urge Ofwat to address this explicitly in its development of wholesale charging rules.

Yours sincerely

Aileen Boyd
Regulation Manager

Response to consultation questions

Q1 Do you have any specific views on the draft rules for 2016-17 included in appendix 2? Are there any other rules that you consider should be included?

We have comments on the Information requirements annex of the proposed charges scheme rules.

1. New appointees have not been required to provide a statement of significant changes, as described in paragraph A2, in the charge setting processes up to now. We suggest that the proposed rules are amended to avoid requiring these from new appointees unless they plan to introduce significant changes to their own way of setting charges, independently of how their upstream incumbents are setting their charges. In the absence of the new appointee introducing any significant change in its own approach to setting charges, then the statement from the relevant incumbent(s) should also cover the new appointee's area, where the relative price control constrains retail charges to be no higher than the equivalent incumbent charges.

It is also the case that the proposed timescale for production of this statement would be difficult for new appointees. Paragraph A2 proposes that the statement should be provided three weeks before publication of the charging scheme. Rule 26 requires new appointees to publish no later than 22 February prior to the charging year. This date is approximately three weeks after incumbent water companies are required to publish their charges schemes, under rule 9, on the first working day of February. Thus the required date for the provision of a new appointee statement of significant changes falls at approximately the same time as the new appointee first has sight of the incumbent charges, when it would be impossible for the new appointee to have completed any assessment of those charges. We do not believe this is either workable in practice for new appointees or actually necessary, since the incumbents will be providing Ofwat with statements of significant changes, which will effectively cover charges in the downstream new appointee areas, at an earlier date.

2. It is not clear what is meant by 'additional information' in paragraph A1 (c) of the annex.

Q2 How best can site area-based surface water drainage charges be adopted? And what lessons can be learned from how companies have moved to this basis so far?

As a new appointee, SSE Water is constrained to charge retail customers no more than the relevant incumbent water company's retail surface water charges. There will be no issue with this provided that the incumbent water company sets wholesale charges to SSE Water for surface water which do not exceed what it is able to charge at retail level and in fact allow a wholesale/retail margin for SSE Water with respect to this service. We wish to highlight the possibility of mis-matches developing between the incumbent water companies' wholesale and retail charges for this service so that Ofwat can be mindful of this in finalising guidance for retail and wholesale charges in this area.

For example, it could happen that an incumbent water company seeks to apply an area-based surface water charge to the entire geographic extent of a new appointee's area, as a wholesale charge. This would clearly recover far more revenue for the incumbent than it would have been able to charge to individual properties in the new appointee's area if it, rather than the new appointee, had been serving that area. It would also impose a trading

loss for the new appointee with respect to surface water charges, as aggregate wholesale charges would significantly exceed the sum of retail charges capped at the incumbent's retail charge level for individual properties. We believe that a precautionary principle should be established in charging rules that incumbent wholesale charges for site-specific services such as surface water drainage should be set no greater than the amount that the incumbent could collect at retail level for the services, minus an appropriate retail margin for the downstream water companies being charged the wholesale rate for the services concerned.

Q3 Do you agree with our proposed threshold for 'significant' bill increase? If not, is there evidence for a more suitable threshold? And how this can be assessed for different customer types?

Q4 Do you agree with our current preference of companies publishing their Board's assurance statements?

Q5 Do you consider that the Board's assurance statement should cover anything else than what we propose above? No

Q6 Do you agree with our current preference for companies to submit a statement of significant changes?

We consider that there are only limited circumstances in which it would be appropriate to require new appointees to submit a statement of significant changes. We have made comments in response to question 1 on how the annex to the proposed charging scheme rules could be amended to take a more proportionate approach.

Q7 Do you have any specific views on the proposals included in chapter 4? Are there any other rules or issues that you consider should be consulted on next year?

We have set out some thoughts in our covering letter on topics of interest to new appointees.

Q8 Would it be practicable and/or desirable to include all non-primary charges in the wholesale charges scheme?

Q9 Do you have any specific views on the requirement to publish final wholesale charges for non-household customers no later than the first week of January?

Q10 Do you agree with our outline proposal that indicative wholesale charges be published in July and October?

Similar issues exist for new appointees in the timeline for producing wholesale charges as for the retail charges covered by charges schemes. New appointees need to see relevant incumbent wholesale charges before they can finalise their own wholesale charges.