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Phil Griffiths
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10 December 2015

Dear Phil

Ofwat consultation on the review of non-household retail price controls

We are pleased to be able to respond to Ofwat's consultation on the review of non-household retail price controls. We have attached our responses to the specific questions posed.

We hope that our comments are useful. Do not hestiate to contact me if you have any queries or would like to discuss our comments in more detail.

Yours sincerely

Jean Spencer
Regulation Director

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an AWG Company

Ofwat consultation on the review of non-household retail price controls

Q1 Should this review focus only on issues relating to the non-household retail price controls and the default tariff price caps?

See our response to question 2.

Q2 In considering non-household retail issues, should this review allow for the reallocation of costs and margins between default tariff price caps, but with the constraint that aggregate levels of non-household retail costs and margins remain the same as in the existing controls, consistent with the expectations set out in the final determinations?

In our Business Plan[1] submitted to Ofwat in December 2013 we set out our views on the non-household retail price control. We said that there needed to be sufficient retail net margins to enable the non-household retail business to:

- Be financeable in its own right as a stand-alone business;
- Have sufficient cash inflows to cover cash outflows so it can finance its working capital requirements. It should be noted that at that time wholesale/retail payment terms were assumed to be 30 days in arrears;
- Make an appropriate profit commensurate with the business risks it faces, such as high market implementation costs, diseconomies of scale resulting from churn of our customer base and higher future input costs.

Of importance, we also stressed that the overall level of net margin needed to be sufficient to allow for profitable entry to the market and not lead to foreclosure of the market via margin squeeze.

To fulfil these requirements we proposed that the net margin should be 5.3%. However, Ofwat concluded that the net margin should be 2.5%.

Our views on the objectives above have not changed. However, there are a number of key areas which have changed.

In the consultation document (page 12) Ofwat suggests that the 2014-15 Regulatory Accounts indicate that costs are generally rising across the water sector but without further information it is difficult to draw firm conclusions about the causes of these changes. On the basis of our experience as we prepare our non-household retail business for market opening, we can provide further information about the causes of these increased costs.

In particular, it is worth noting the following:

- Level playing field requirements. Following Ofwat's consultation on level playing field requirements in September 2013, the Market Architecture Plan was published by Open Water in July 2014. It set out the importance of arms-length operations between retail and wholesale businesses and highlighted that incumbent companies needed to understand and address the perceived risks or face challenges from entrants. Whilst it is clearly for

[1] Section 7: Financing the plan, Our Plan 2015-20, December 2013

companies to decide how to address the risks, a trade-off was described between higher upfront transitional costs and lower ongoing compliance costs versus lower upfront transitional costs and higher ongoing compliance costs. Either way, there are increased costs associated with mitigating these risks. In the light of our experience of dealing with competition law compliance challenges, and the huge costs and management effort needed, we have opted for a robust approach to separation. This means higher upfront transitional costs associated with acquiring separate accommodation, separate IT and separate telephony for our non-household retail business. We consider that this approach is the most efficient and cost effective compared to incurring higher ongoing compliance costs associated with dealing with multiple compliance challenges.

- The detailed design of requirements for the non-household retail market. We have now completed this, which includes:

    - the design, build and testing of systems which will interact with the market operator's central system;
    - the transfer of all non-household customers from the household billing system to the non-household billing system;
    - the transfer of all services and accompanying resources to manage non-household customers. These services include payment processing and debt management;
    - process mapping, aligning and documenting all internal processes against the market requirements; and
    - Undertaking testing of internal processes and training for all relevant staff.

  Back in 2013-14 it was not possible to understand or estimate the extent of the work needed or the costs involved. These costs are necessary for retail market opening.

- The Wholesale-Retail Codes. These set out the payment terms between wholesalers and retailers post market opening. Unless retailers have a minimum credit rating of BBB- (which most will not because of their size and history, without an implicit cross-subsidisation from the associated wholesale business) then retailers will need a Letter of Credit or a Guarantee or need to pay wholesalers in advance via a deposit account or an Escrow account. This is a fundamental change in assumption compared with the 2014 non-household retail price review and requires additional cost and/or significant working capital.

Using published industry data from the 2014-15 Regulatory Accounts we have undertaken some analysis of industry operating costs and the impact on net margins – please see Table 1 below.

In column 1 we set out the actual non-household operating costs for each company as reported in the 2014-15 Regulatory Accounts. Column 2 sets out the non-household operating costs which were allowed in 2015-16. It can be seen that for most companies, their actual operating expenditure in 2014-15 is significantly higher than that allowed in 2015-16. Column 3 indicates the efficiency saving which is required between 2014-15 and 2015-16 in order to meet the allowed operating expenditure. Note that for some companies, this is substantial. For example, two companies need to make efficiency savings in their retail costs of more than 44% and nine companies need to make efficiencies of greater than 20%. Against a general backdrop of increasing costs in preparation for retail market opening this presents a significant challenge.

Column 4 indicates the actual 2014-15 operating costs as a percentage of 2015-16 non-household turnover. Column 5 shows the net margin which results if the efficiencies shown in column 3 are not achieved. This puts companies in an extremely difficult position where costs are justifiably rising but prices cannot increase because of the default price caps. Our analysis illustrates that only three companies would achieve a net margin of at least 2.5%. Most companies (more than 80%) will be at risk of margin squeeze and twelve companies are almost certainly at risk of margin squeeze (those with a projected net margin of less than 2%).

Table 1

	NHH 2014/15 actual opex £m	NHH 2015/16 allowed opex £m	Efficiency saving required to hit 2015/16 FD %	2014/15 opex as % of 2015/16 NHH turnover %	Resulting net margin if gap remains %	Potential margin squeeze
Affinity water	4.0	3.8	6.2%	6.7%	2.1%	yes
Anglian	9.8	9.0	7.9%	4.0%	2.2%	yes
Bristol	1.6	0.9	44.7%	6.6%	-0.4%	yes
Dee Valley	0.5	0.2	46.4%	7.4%	-2.1%	yes
Dwr Cymru	6.5	7.5	-15.8%	4.0%	1.9%	yes
Northumbrian	6.3	4.8	23.3%	3.3%	1.7%	yes
Portsmouth	0.4	0.3	25.1%	4.6%	1.4%	yes
Bournemouth	0.6	0.4	28.3%	4.2%	1.3%	yes
Severn Trent	14.9	15.8	-5.7%	3.7%	2.7%	no
South East	1.9	2.3	-19.0%	3.9%	3.2%	no
South Staffs	1.9	2.0	-3.1%	7.2%	2.7%	no
South West	2.7	2.1	23.4%	2.2%	2.0%	yes
Southern	5.8	5.1	12.2%	4.1%	2.0%	yes
Sutton East Surrey	0.6	0.5	16.3%	5.6%	1.6%	yes
Thames	24.7	18.9	23.3%	6.3%	1.0%	yes
UU	29.9	22.4	25.1%	5.7%	1.1%	yes
Wessex	3.8	3.0	20.3%	3.1%	1.9%	yes
Yorkshire	5.7	5.1	9.8%	2.7%	2.2%	yes
Industry total / average	121.6	104.2	14.3%	4.5%	1.6%	yes

These issues need to be taken into account by Ofwat in its considerations. Should it be allowed to continue, the logical outcome of this situation is that the market is potentially unfairly distorted by the ceiling created by the current default tariff caps with the risk of margin squeeze such that entrants will be unable to enter the market. This will be to the detriment of customers. Companies will be at serious risk of breaching competition law which will undermine the credibility of the market and risk destroying confidence. Furthermore, Ofwat is unlikely to be meeting its consumer objective by promoting effective competition. Neither is Ofwat meeting its duty to ensure that companies are able to finance their functions.

Q3 How can the transparency in the mapping of tariffs to the default tariff caps be improved?

We support increased transparency so it can be seen how published tariffs are related to the default tariff caps. As the default tariff caps are based on average revenue per class of customer, it might be possible to use average bills to show how these compare to the default tariff caps.

Q4 Do you consider it appropriate to encourage companies to increase the consistency in default tariff cap structures and consider carefully whether the diversity in the present levels of default tariff caps is properly justified?

The diversity in the current levels of default tariff caps reflect the historic development of customer tariffs across the industry and follow the strong steer given by Ofwat at the time that customers would be best served by continuity in the structure of non-household tariffs following the introduction of wholesale/retail charges. Primarily this diversity is borne out of companies' need to structure their charges to be reflective of the cost to supply, which will be informed by the cost allocation process each company undertakes.

It is reasonable to assume that retailers will seek broadly to mirror wholesale tariff structures in their own retail tariff structures, to ensure (wholesale) cost recovery, as well as maintain bill stability for customers. So whilst retailers may look to refine retail cost recovery, it is unlikely that this would override the need to follow the wholesale structure.

Therefore, there exists tensions between the competing objectives of standardisation, cost reflectivity and bill stability, not only at default tariff level, but also at the level of wholesale tariffs. Consequently, increased standardisation of tariffs, presumably intended to facilitate market entry will not only have a negative impact on cost reflectivity and bill stability but also on innovation.

One of the major benefits of greater competition is to promote greater economic efficiency, including, the reduction of cross subsidies. We might expect that retailers will exert pressure on wholesalers to provide wholesale services in a different, more flexible and customer oriented way. Wholesalers should be able to respond to this, reflecting their own company cost structures. This opportunity could be severely impaired if wholesalers are unable to refine their individual pricing strategies or had to respond collectively, as an industry, and could lead to inefficient outcomes.

We recognise that expertise is needed to understand the variations in charges across companies, however, one of the skills which will set market leading retailers apart from the rest will be the ability to deal with multiple wholesale tariff structures on behalf of customers with a nationwide presence. Therefore we are not persuaded that there should be greater simplification or a move towards uniformity in retail or wholesale tariff structures.

Q5 What information should companies be asked to provide and publish in support of any proposals (including for no change) they make in respect of their default tariffs caps?

Companies should provide an explanation of what they are proposing and why, focusing in particular on what has changed (if anything) since 2014. They should explain from where the information they are providing has originated (for example from their internal Management Accounting system) and explain whether costs are direct costs or have been apportioned. Where apportioned, companies should explain the basis (the cost driver) on which apportionment has been made (for example, by customer numbers, number of meter reads, number of bills etc). They should also include how they have approached recovery of fixed and variable costs using fixed and variable tariff rates. Companies should explain how they have apportioned the net margin across different customer classes. Companies should explain how they have endeavoured to ensure that their approach is cost reflective and that they are compliant with competition law.

Q6 Do you consider it appropriate to allow companies the option not to update their cost and margin attributions and allocations, and so retain their existing default tariff price caps?

Yes. If companies are sure that their existing default tariff price caps fully and accurately reflect their current position then they should be allowed to retain their existing default tariff price caps.

Q7 Is a three-year duration appropriate for the next non-household retail price control and if not what is the most appropriate duration and why?

Yes. We think that this will provide the required stability for an appropriate length of time during which the market will open and develop. A shorter duration is unlikely to provide sufficient evidence about how the competitive market is developing. We agree that there is merit in reviewing the next non-household retail price control arrangements at the same time as the other price controls for wholesale and household retail.

Q8 Do you agree with the proposed timetable for this review, with a statement of method in April 2016, draft determinations in September 2016 and final determinations in December 2016?

No, we have some concerns with the proposed timetable.

Companies need more time for preparing and submitting their proposals. This is because there are likely to be queries and clarifications needed on the methodology statement and the data tables, reducing the time available, and the resources needed within the companies will be the same resources also needed to complete year-end work. In addition, companies need sufficient time for Board approval. For these reasons, Ofwat should publish its methodology statement and data table requirements one month earlier, by 8 March 2016.

Subject to an earlier publication of the methodology statement and data table requirements as above, a submission date of 15 June 2016 is acceptable. Because of the time needed to prepare annual Charges Schemes and ensure that the market operator has the correct charges within the central system from which to calculate settlement charges, the final determinations need to be published significantly earlier, by 17 October 2016. Working backwards from there, we think that companies and stakeholders need to respond to the draft determinations by 14 September 2016. Correspondingly, Ofwat needs to publish the draft determinations by 16 August 2016. We've amended the draft timetable below, highlighting our proposed amendments in red for clarity.

We think this represents a fair balance of time between Ofwat and the companies and will provide sufficient time to ensure final charges are completed ahead of market opening on 1 April 2017.

Proposed date	**Consultation date**	**Milestone**
11 Dec 2015	11 Dec 2015	Closing date for this consultation
8 March 2016	8 April 2016	Ofwat publishes statement on method and data table requirements for the review
15 June 2016	15 June 2016	Companies submit changes to their cost and margin allocations with data tables and supporting evidence.
16 August 2016	16 Sept 2016	Ofwat publishes draft determinations
14 Sept 2016	28 Oct 2016	Companies and stakeholders respond to the draft determinations
16 Oct 2016	16 Dec 2016	Ofwat publishes final determinations
1 April 2017	1 April 2017	New non-household retail price controls and charges come into effect and the retail market opens.