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Dear Phil,

Thank you for the opportunity to respond on this consultation on the 2016 price control for Non-Household Retail.

We welcome the thoughtful analysis set out in the consultation and are supportive of the approach proposed. We particularly agree with Ofwat's position that it is appropriate to require compelling evidence for any change to the scope of the price control to include allowed costs and margins.

We provide our views on each of the questions posed below.

Please let us know if we can be of further assistance on this.

Yours Sincerely,

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Key consultation questions

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

We agree that it is appropriate for this review of the non-household retail price control should take place in 2016, consistent with the approach set out in the PR14 final determination.

We also agree that the scope of this review should accordingly be limited to the retail non-household price control, and not address the retail household or wholesale price controls.

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 our final determinations?

We agree that the review should allow for the reallocation of costs and margins between default tariff price caps, to take account of the most recent available data.

The consultation considers whether two key issues should be revisited at this control, cost allowances and allowed net margins. We provide our thoughts on each of these issues in turn.

Cost Allowances

There are three categories of costs relevant to the retail non-household control: General operating costs, specific market set-up costs and inflationary costs.

For general operating costs, we agree that these do not need to be revisited. This is partly because there would be a danger of recognising costs in two separate controls.

In respect of market set-up costs, particularly the costs of integrating billing systems with the new central market system, we consider that there is merit in now including these efficient costs in the control. This is because:

- These costs were not allowed at PR14 due to the level of uncertainty around them;
- Companies approaches are now more developed than at the time of submission of PR14 business plans, and costs are therefore better understood; and
- If tariffs do not reflect the efficient costs of market setup then the scope for entry by new retailers will be reduced, as they would have to incur these costs.

In addition, as the level of ongoing payments to the market operator can now be more accurately forecast, we believe it is appropriate that an allowance for these should be included from 2017 onwards.

Ofwat's PR14 determination effectively assumed that no inflation would apply to the retail non-household control, in that where inflationary price pressures occurred companies were expected to offset these by efficiency. This creates the risk that if the implied efficiency target is higher than

expected due to higher inflation, margins will be squeezed which might impede the ability of new entrants to compete in the market.

We suggest that Ofwat re-considers whether this policy position is likely to be sustainable through the price control period, or whether it may be appropriate to allow for some inflationary increase in costs from the level assumed at the PR14 determination, which was based on 2012/13 cost levels, and that which is likely to occur in the duration of the rest of the price control.

Allowed Margin

We do not have any compelling evidence that the margin would be greater than 2.5% in a functioning market. However, this margin would be post-discounts and therefore may be too low for a default tariff. If the margin is too low for a default tariff it may act to deter entry and lead to lower long-term benefits. Consequently, we consider that it is appropriate for the 2016 price control to review the level of net margin to be applied to default tariffs.

Other consultation questions

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

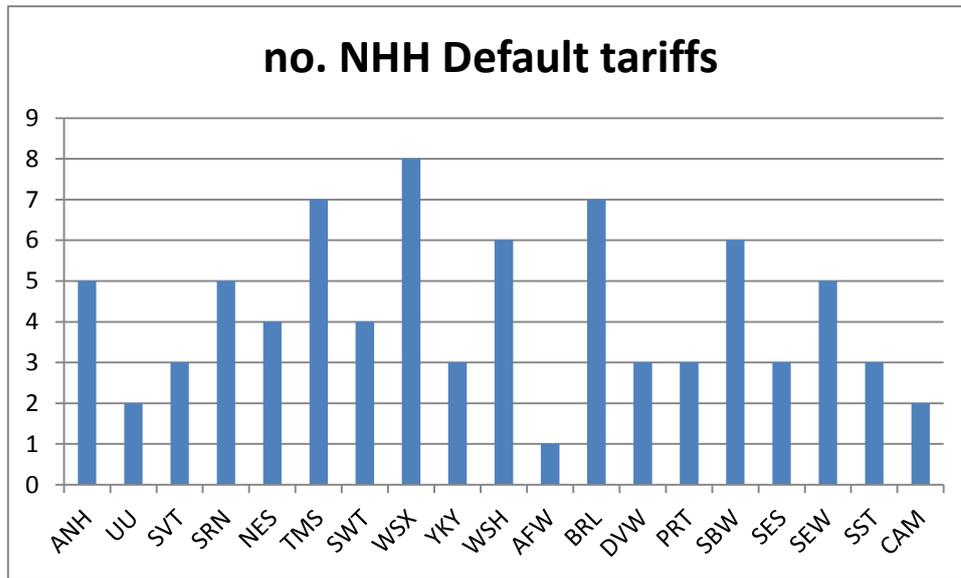
At present, for Bristol Water our default tariff structure maps directly to our non-household charging structure, so we consider that an appropriate level of transparency exists.

If steps are taken to consolidate the default tariff structure across the industry, as discussed in question 4 below, this may lead to incidence effects that will need to be carefully managed.

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 information provided in Appendix B of the consultation suggests that we offer one of the larger numbers of default tariffs with seven measured tariffs.

Figure 1 - No. of Default Tariffs by Company 2015/16¹



Our current default tariff structure was selected so that it aligns with our previous major user and non-household tariff structure. This minimised the potential for incidence effects arising from the transition to separated retail and wholesale price controls.

Going forwards, we recognise that whilst there are differing costs to serve non-household customers depending on the consumption level, and consequently the infrastructure required to provide that consumption, these differences may not be the same for retail costs.

We consider that it would be possible to amend our current default service offerings to change the number of default tariffs we offer. However, we consider this would reduce cost reflectivity.

To enable consistency, a decision at industry level as to the appropriate number and consumption levels for default tariffs would need to be agreed, and set out in the requirements for the 2016 retail non-household price control. This would need to be completed before the methodology statement in April 2016.

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 tariff caps?

We would expect the required information to include, for each default tariff:

- no. customers
- volumes
- costs
- revenues

We would also expect policy decisions on changes to the default tariff structure and associated default levels of service to be supported by evidence from stakeholder and customer engagement.

¹ Calculated from data provided in Appendix B of Ofwat's consultation document

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?

We agree that if the evidence from companies' review of available information suggests that no change to the existing price caps is required, there should be no obligation for companies to make a change.

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?

We agree that at this stage a three year duration for the retail non-household price control appears appropriate. There are two key reasons for this:

- 1) This would allow the retail non-household price control to be revisited as part of the 2019 price review. Whilst in future it need not necessarily be the case that wholesale and retail controls are aligned, given the impact of cost allocations that are still relatively new on the different price controls, alignment of these allows for a rounded decision on costs.
- 2) A three year control would allow for a further reassessment of costs and tariff structures once the market has begun operating. At this point, more information may have been revealed about actual costs and customer behaviour in response to market opening. It would minimise risk for a price control to be able to take that information into account in 2019, rather than setting a longer duration in 2016.

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

We agree that the timetable of submission of information in June, draft determinations in September and final determination in December is acceptable and should be achievable for companies and Ofwat.