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Phil Griffiths
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By email only to: NHHRetailPriceReview@ofwat.gsi.gov.uk

Dear Phil

Response to OFWAT Consultation: Review of non-household retail price controls

This response is provided for and on behalf of Independent Water Networks Ltd ("IWNL") a member of the Brookfield Utilities group. We welcome the opportunity to respond to the above-mentioned consultation (the "Consultation").

On a more general note, we support Ofwat's efforts in facilitating a water and wastewater market in which prices are intended to be transparent, fair and cost-reflective and thus support the work currently being undertaken to ensure the successful opening of the non-household retail market in 2017.

We have set out our responses to your specific question in the Annex.

Yours faithfully,

Mike Harding

Head of Regulation

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

No, IWNL believe that the market reforms will have a significant impact on existing competition in asset ownership. We believe that the review therefore needs to set out a specific requirement for incumbents to develop appropriate and cost reflective tariffs for new entrants to ensure, amongst other things, that non-household customers situated on new entrant sites can access the benefits of retail competition.

From the outset, one of our key concerns is that the incumbent water companies are charging or proposing to charge new entrants using their newly developed wholesale charges. They have developed these tariffs for the purpose of charging water retailers and so the tariffs incorporate the costs of providing water and sewerage services all the way to the door of the customer premises. The only justification that incumbents have offered for applying these wholesale tariffs to new entrants is that these are slightly cheaper and will therefore save new entrants some money. IWNL believe that the incumbent wholesale tariffs are inappropriate for the purpose of charging new entrants because we connect further up the incumbent network and incur significant 'last mile' operating costs.

IWNL believe that a failure to develop specific new entrant tariffs will result in certain non-household customers not being able to access retail competition. By way of example, IWNL has a number of large customers being charged broadly the same tariffs as those which IWNL pays to the incumbent at the site boundary[1]. The margin between an incumbent's large user retail and wholesale tariffs is wafer thin because it only reflects a discount for the retail elements of the incumbent's charge. This retail difference is small by comparison to the 'last mile' costs that a new entrant incurs which will include costs such as network opex, capital replacement, capital maintenance, water sampling, metering, pumping station costs, bad debt and water losses etc.

In developing its own wholesale tariffs, a new entrant will, in the first instance, look to pass through the incumbents' wholesale boundary charges. In addition to this 'pass-through' the new entrant must add its own 'last mile' costs. As previously mentioned, these 'last mile' costs are significant compared to an incumbent's retail costs so that adding these costs to incumbents' wholesale tariffs will inevitably produce new entrant retail tariffs that are higher than the incumbent's retail tariffs. The consequence of this will be:

- Non household customers on new entrant sites are likely to complain that water suppliers are not able to offer them more competitive prices unless they relocate within the incumbent's area.

- Water suppliers are likely to complain that the new entrant wholesale tariffs are significantly higher than the corresponding incumbent wholesale and retail charges thus rendering them unable to compete for non household customers on new entrant sites.

- Developers are likely to become unwilling to offer new developments to new entrants irrespective of price because they will be concerned that the foreclosure of retail competition to non-household customers on their development will impact on their ability to sell or lease the non-household developments. This is of particular concern because the vast majority (if not all) of new entrant inset sites are large developments which include at least some non-household supplies. Failure to

[1] The incumbent wholesale and retail tariffs only vary by a small c£50- £200 amount depending on which volumetric threshold applies.

resolve this issue could therefore foreclose the few opportunities that are accessible to competition from new entrants. Note, a similar issue occurred in the gas industry because gas suppliers refused to supply non household customers connected to independent gas transporter networks because their IT systems only worked with Nation Grid systems.

In summary, IWNL therefore believe that incumbents need to be given an explicit instruction to develop new entrant boundary tariffs as part of this process in order that non-household customers on new entrant sites are able to access the benefits of retail competition. Such tariffs should consider the avoided last mile costs and the fundamental requirements of competition law, in particular cost reflectivity and the need to ensure that all sites are economically viable for competition.

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?***

IWNL believe that this review should allow for the reallocation of costs and margins between default tariff caps. We do not however agree that the aggregate levels of non-household retail costs and margins should remain the same as they are in the existing price control without proper consultation and consideration on the existence and extent of any cross subsidies that may currently exist.

The implication of allowing the constraint at this stage of the process is that cross subsidies between different customer groups may never be identified, quantified or disclosed. The constraint will merely serve to protect and maintain any imbalance of charges long into the future as we move forward with the implementation of the market reforms.

The purpose of the market reforms is to introduce retail competition into the market. Cross subsidies can distort markets and create barriers to competition. Given this we believe that the proposed constraint presents a risk to the success of the market reforms and that this risk outweighs any perceived benefit that may arise from price stability. We therefore believe that it is crucial for new tariffs and cost allocation methodologies to be developed around the principle of cost reflectivity in order that:

- Customers can be assured that they are paying a fair and cost reflective charge for the services that they receive.
- Any cross subsidies that exist are identified, quantified and properly disclosed and appropriate actions considered for resolving any such cross subsidies.

There are other alternatives to the proposal that aggregate levels of non-household retail costs and margins be permitted to remain the same as in existing controls. One example of such alternative solution is ‘transitional relief’, i.e. the process of migrating customers from one set of charges to another such that there is a smooth glide path transition rather than an immediate step change. Ofgem used transitional relief on customers who were affected by tariff rebalancing which occurred with the introduction of new extra high voltage “EHV” tariffs in April 2011.

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

We envisage that incumbents will wish to set out their tariffs alongside the associated default tariff cap on schedules within their published charging statements in order to illustrate (a) which default tariff cap applies and (b) the level of any additional discount being offered. We do however have some more general concerns around how the default tariff caps have been set.

Firstly we believe that the diversity that is evident in the pricing caps could have been avoided had the water companies first been required to develop a common charging methodology. Such methodology would ensure consistency in cost allocation policies which in turn would drive greater consistency in the default tariff caps.

Secondly, we don't necessarily agree with the way that default tariff caps have been set. The approach which has been taken seems to imply that retail costs vary according to the turnover of the end customer. We do not believe this is the case; instead they are driven by physical activities such as meter reads, customer service, billing etc. We are not clear to what extent customer service costs even vary between small and large customers let alone the relevance of how the three water, sewerage and surface water components of the bill impact on retail costs. Our concern therefore is that the default tariff caps may be developed without proper cost reflectivity.

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?***

We believe that it is crucial for water companies to increase the consistency in their default tariff price caps.

Clear and transparent price signals play a very important role in developing competition. For example IWNL have witnessed the step change in the level of competition in the electricity industry from c.6% to +50% between 2010 and 2013 as a direct consequence of the introduction of the Common Distribution Charging Methodology "CDCM" in April 2010. The CDCM was introduced at the request of the regulator, Ofgem who primarily wanted to improve and bring more consistency to the process of price regulation.

IWNL strongly support the introduction of a similar common charging methodology in water and believe that in addition to the above benefits, it will allow the diversity in the current default tariff price caps to be unpicked and resolved.

IWNL believe that there is far too much diversity in the various tariff structures and charging methodologies being deployed by water companies. Apart from clouding the price signal which deters new entrants, these differences in methodology also produce vastly different price signals against other water companies. A simple example of this is how vastly different new entrant incomes for domestic plots are depending on which water company regions they are situated in and on the size of the site on which they are situated. In practice a domestic plot will have the same average capital cost e.g. length of main, service and meter and customer service and billing costs irrespective of whether they are situated on a 50 plot site or a 5000 plot site. The income that a new entrant earns however varies dramatically.

***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?**

IWNL consider this to be a complex issue. Benchmarking is possibly one of the most powerful ways to challenge the accuracy of any calculations. Ideally, we would therefore like a standard pro-forma to be developed so that all companies are required to disclose the same information in the same format. This would then facilitate a quick and effective benchmarking process to be undertaken where any outliers could be identified and resolved.

***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?**

No. We believe that incumbents need to undertake a full analysis of their costs, margin attributions and allocations and work towards greater tariffs that ensure full cost reflectivity. Some tariff disturbance is almost inevitable with a reform of this scale although the tone of the proposed approach appears to be more focused on instilling market confidence by maintaining the status quo of existing charges.

***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 believe that a three year duration is appropriate for the next non-household retail price control.

***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?**

Yes, we agree with the proposed timetable.