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Dear Phil

Consultation on the review of the non-household retail price control

Thank you for consulting on Ofwat's proposal for the scope and timetable for the non-household retail price control, providing all stakeholders with an opportunity to help shape this review.

We consider the review particularly important in providing an opportunity for all parties to focus on this new and evolving area which was in danger of being overshadowed by the much more material issues involved in the wholesale and household retail components of the last Price Review (PR14). This was the reason we originally supported the opportunity provided in the PR14 Final Determination for a review after two years. Subsequent developments have reinforced the value of this review, to enable significant changes in the evolution of market opening arrangements to be taken into account. Doing so will help contribute to the industry's common objective of ensuring that market opening is successful.

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

The scope clearly expressed in the PR14 Final Determination remains valid. As noted above, the review provides a valuable opportunity for a focused review of a new form of control for a new environment and it should not be distracted by looking beyond the non-household retail price controls and default tariff price caps. However the scope of the review ought to take into account significant new evidence relevant to these controls. We consider that there is compelling new information that needs to be taken into account.

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?

There are two key new considerations that we think should be taken into account in considering the overall level of non-household retail costs and margins.

First, non-household retail costs should take into account the increase in industry's agreed central costs, as approved in MOSL's Business Plan, over and above the allowances already

built into PR14 Final Determinations. These costs are clearly attributable to non-household activities and, whilst PR14 provisions might have been included in wholesale controls, there is no compelling reason why the increase in costs should not be included in non-household retail controls. This change would not affect the efficiency incentives already built into controls as the costs are common to the industry and are clearly unavoidable if market opening is to be a success. Moreover, any equivalent increase in company-specific costs for market opening would be left to be carried by companies. This achieves an equitable sharing between customers and companies of the incremental costs arising from better information on the costs of this public policy decision emerging since the cost projections included in PR14 Final Determinations were developed.

Secondly, the allowed net margin needs to be aligned to the payment terms (and therefore working capital requirements for retailers) mandated by the market codes. This would clearly address some of the perceived difference from allowed margins in Scotland, and would ensure that the original intent of the margin allowed at PR14 was maintained.

With these two critical overrides, the review should then concentrate on the allocation of retail costs and margins across customer groups.

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

We do not consider “encouraging companies to make ... proposals” on improving the transparency of the mapping of tariffs to the default tariff caps to be an appropriate objective for a review of the overall level and structure of controls. The information we provide each year on wholesale charges should, in combination with the information on net margins and allowed average retail costs, provide retailers and other interested parties with all the information they need to calculate default tariffs for any customer. It is of the essence of a market mechanism that an appropriate level of transparency is achieved through dialogue between market participants. Attempting to regulate the form and scope of such transparency through a price control review distracts from the main purpose of the review – and may indeed undermine its effectiveness.

We would of course be happy to work with any retailer to consider what further information would help them in their understanding of default tariffs.

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?

PR14 Final Determinations enshrined the principle that companies were best placed to determine the structure of default tariffs and did not require any national standardisation. The very good reason for doing this was to avoid the disruptive incidence effects of a mandated national approach. We see no good reason for taking a different approach within two years and still before the market opens. If default tariffs are genuinely too complex for customers and new retailers, the market will quickly marginalise them, which would be strong evidence of an effective market operating.

It is not clear what is meant by “encourage companies to increase the consistency”. Unless Ofwat define a national approach to customer segmentation for default tariffs we are not minded to change our current structure. If each company is independently encouraged to change their structures then we risk ending up with a whole different set of disparate tariff structures.

Any proposal to set a national approach to customer segmentation for default tariff caps needs careful consideration and realistic timelines need to be presented. We agree that it would be

We therefore propose the modified timetable below:

| Date | Action |
|-----------------|--|
| Early February | Ofwat seeks companies' feedback on a draft methodology and data tables |
| End of February | Feedback from companies |
| End of March | Final methodology and data tables published |
| Mid July | Companies submit proposals |
| 1 September | Draft Determinations |
| 30 September | Representations close |
| Mid November | Final Determinations |

Involving companies in the development of data tables will reduce the scope for misinterpretation of requirements and subsequent dialogue and possible resubmissions. This would allow the focus of attention and dialogue to be on matters of substance.

As always, we would be more than happy to expand on any aspect of our response. In the first instance please get in touch with Joanna Campbell, Economic Regulation Manager (JoannaC@waterplc.com, 01737 785 692).

Yours sincerely



John Chadwick
Finance and Regulation Director

companies' responsibility to handle all incident effects. But, even the most well planned and executed handling strategy will leave some customers disadvantaged by the change to their bill. To rush into such a policy would undermine the objective of creating trust and confidence in the sector and in encouraging an active and effective competitive market.

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?

If companies propose to make no change to the allocation of costs and margins it is not clear why the evidence provided during the PR14 price control review has now become inadequate.

Where companies do propose changes they will be able to evidence why the new allocation is more appropriate than that adopted for the existing default tariffs.

It is for companies and their Boards to decide what, if any, external advice is required in support of their position. Requiring a report from expert consultants undermines Board responsibility for their proposals and tends towards a prescriptive approach that specifies the basis upon which expert consultants should provide their opinion.

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. There is no reason to presume that the costs and margins allocated in PR14 Final Determinations are inherently inappropriate and there is no justification for forcing companies to consider alternative cost and margin allocations. If Ofwat considers that some allocations are inappropriate, they should exercise their regulatory responsibilities in a targeted manner by requesting specific information from the companies where their PR14 Final Determinations may be flawed.

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 feel it is appropriate because it aligns all price control reviews. A shorter or longer price control period would mean regulatory decisions that impact on the price customers pay being made at different points in time. This would have the undesirable outcome of increasing volatility in customers' bills.

We would urge you to engage with market participants early on the options for regulation of non-household retail prices from April 2020. The consultation on deemed contracts discussed the need to assess the evidence of the effects of competition on constraining prices before deciding the appropriate regulatory approach. We would welcome early engagement of the form that this assessment could take and the evidence that may be considered.

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. It is not sensible to allow companies only two months (including two Bank Holidays) to produce a plan. The timing is a particular concern as it falls at a time of the year when resources in many smaller companies will be focused on production and dissemination of annual performance reports (and now draft wholesale charges schemes). Similarly we believe that plans could be reviewed quicker. Final Determinations on 16 December are unnecessarily late for proper incorporation into the charge setting process for 2017-18 and may adversely impact on retailers' ability to get ready for market opening.