

Consultation on the review of non-household retail price controls

Severn Trent Water response

11 December 2015

Summary of our response

We welcome the opportunity to provide feedback on Ofwat's review of non-household retail controls. The changes introduced for PR14, including the creation of separate controls for retail, have been the biggest changes to the sector since privatisation. The 2014 price review was a learning process for both Ofwat and companies, so we think Ofwat was right to give companies an opportunity to re-examine the allocation of non-household revenue in advance of market opening. For the new market to succeed there needs to be sufficient margin within the retail controls for rival retailers to compete effectively.

Scope of the review

In our view, this review must focus on issues relating to the non-household control alone. The 2014 determination set a clear expectation that the wholesale and household controls would remain in place for 5 years. Until the market opens, there will be no evidence to demonstrate whether the retail margins Ofwat has set are sufficient or not. Unless there is new information, such as new retail obligations arising from market codes, then we do not think the total level of allowed cost or margin should be re-examined.

Although an early review is possible, we do not think a longer control could be set without a Licence change. We see little advantage from either option unless the scope is widened to consider cost and margin, particularly for years beyond 2020.

Transparency and tariff mapping

It is important to recognise that Average Revenue Controls (ARCs) are not tariffs – they cover the average retail component from several tariffs. Companies could provide information that improves transparency without Ofwat regulating the mapping from control to tariff and we have made some practical suggestions about how this could be done in our response.

In our view, Ofwat should not prescribe the linkage between control and tariff. If both the wholesale and retail charges are tightly controlled, companies will have no flexibility to change. This could make it impossible for a company to respond if a given tariff was creating a margin squeeze. As the enforcing competition authority, we think Ofwat should avoid prescribing particular charges as that could limit the scope of their competition powers.

Consistency between companies

We think that this review should look at the outcome of companies' charges in terms of the margin available for a range of typical customers. The issue with charges convergence is the wide range in the level of wholesale charges arising between companies. Wholesale charges in other regions are not available to customers, so the structure of other companies' controls is not relevant to them. Driving convergence – particularly if extended to wholesale – will cause incidence effects and those who see their bills increase may well question the benefit of a charge aligned to a customer at the opposite end of the country.

As we set out in our response to the 2014 review, we welcome this opportunity to re-examine our non-household controls. While we think that companies should be able to retain their existing ARCs if they choose, we are undertaking a full review of our non-household

retail charges to ensure that we comply with all our obligations in advance of market opening. The consultation proposes a short timetable between the finalising its method and company submission, so we think it is important that there should be continuing dialogue between Ofwat and companies. This will ensure that these controls have the best chance of enabling effective competition.

If you would like to discuss any aspect of this response further, please do not hesitate to contact myself or a member of my team.

Kind regards

A handwritten signature in black ink that reads 'A J Ball'.

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Our responses to the specific questions in the consultation are set out below.

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

Yes, it should only focus on non-household retail and the average retail revenue allowances per customer group (note that the control set in the FD is not termed a default tariff price cap).

PR14 was the first time that Ofwat has set binding price controls for different elements of the value chain. Given that there has been no legal separation between retail and wholesale, the division of cost and revenue between these controls is based on accounting separation. Although this information is becoming more mature, there have been many changes in the way that companies allocate their costs since accounting separation began (and even during the course of PR14).

It is likely that companies will gain a better understanding of their non-household retail costs in the new environment once the market has been in operation for two years – by the time of the next periodic review. We are not sure that there would be compelling new evidence that would support reallocation of costs between controls so soon after PR14.

We believe the review must be limited to the non-household control. The Final Determination set a clear expectation that the other controls – wholesale and household retail – would remain in place for five years. In the absence of strong justification, widening the scope of the review beyond these limits – particularly if this involved reopening the wholesale control - would be contrary to the expectations that Ofwat set out in its Final Determination and our decision to accept the Final Determination. The Final Determination was very clear that only the NHH retail control would be reopened in 2016. Changing this clearly set out decision could affect perceptions of regulatory risk in the sector, which would have a long-term implication for companies' cost of capital.

Companies will be working towards PR19 as soon as the market opens – this is early enough to consider how the new arrangements are working and to reappraise what costs and margins should be included within each control.

2. 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?

Yes, the aggregate levels of NHH retail costs should remain as set in the Final Determination. The FD we accepted made it clear in Annex A6 that *“For the avoidance of doubt, we are not proposing for the scope of the 2016 review to include new non-household retail cost claims from the companies. The costs we have set out in the company-specific appendices are expected to remain the basis of our controls throughout the period from 2015 to 2020.”*

We think it is not realistic for customer bills in aggregate to increase in 2017/18 to facilitate larger margins. With this constraint, higher margins for non-household could only be achieved through a reallocation of revenue from one of the other controls. We do not think this option is available.

For additional cost or margin to be allowed, the key question would be the strength of new evidence. The consultation argues that rising costs in 14/15 are not, in themselves, sufficient evidence and it is too soon to know whether there will be effective competition on the basis of the allowed margins; this will become apparent when the market opens.

If there are new obligations on non-household retail, then it might be legitimate to consider an increase in allowed cost or margin. This might include new requirements from the Open Water programme, such as different payment terms. However, the increase in the cost of implementing the market operator is already being absorbed by wholesalers. It would not be reasonable for wholesale revenues to be further reduced in order to pay for new retail requirements. In any event, we believe that reopening wholesale controls would require a Licence change.

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

We agree that it is important to improve transparency and we suggest that Ofwat should look at how this could be achieved without imposing excessive restrictions on companies' ability to set charges.

It is important to recognise the difference between the arrangements in Scotland and those that Ofwat has put in place. In Scotland, "default tariffs" were the continuation of the actual customer price at market opening – i.e. the sum of wholesale *and* retail components. In England, Ofwat has implemented an Average Revenue Control (ARC) on the non-household retail portion of the change. It is the average amount spread across a number of tariffs and is also a control on the *retail component* alone.

Using Severn Trent as an example, there are 40 distinct charges within one ARC for unmeasured surface water drainage. The average retail component within this group of charges is set equal to the amount determined by Ofwat. But individual customers will pay differing amounts of retail charge.

We think there are two ways in which companies could improve the transparency of charges:

- Set out a tariff map showing which tariffs might apply in each of their ARCs.
- Provide a table of indicative charges for customers with standard characteristics.

Tariff maps

The relationship between tariffs and ARCs is not simple. Like most companies, we have bands based on consumption. However, within each ARC customers will pay some

charges that are not related to volume – for example surface water drainage charges are related to site area. It is quite possible to have a low volume customer such as a warehouse on a very large site. This type of customer would pay a large bill and the retailer would face significant costs (bad debt and working capital) related to that bill.

Tariffs like this will apply across several bands and will not be related to consumption. Mandating a very simple charge – such as a single fixed charge for all customers in an ARC - would not be appropriate. It could impose a margin squeeze in a case like the one above. So we think that there has to be an element of each retail charge that is related to the size of the bill.

Indicative charges for standardised customers

We think the objective of transparency could be achieved by requiring companies to publish a range of indicative retail charges for customers with characteristics which Ofwat would define. This is an approach Ofwat used to do in Tariffs reports and which Ofgem have taken in their Supply Market Indicator analysis¹. While there are a wide range of tariffs within company schemes, most customers see a very simple charge. For example, 99% of Severn Trent's measured non-households are charged on standard rates.

It would be relatively straightforward for companies to set out the typical regulated retail charge that would apply to a customer with a given set of characteristics each year. For example:

£, 2015/16	Wholesale	Retail	Total	Description
Measured Water: 60 m ³ /a	85.52	35.80	121.32	Details of the specific tariffs applied to derive the indicative charge.
Measured Water: 100 m ³ /a	142.52	37.85	180.37	
Measured Water: 1 ml/a	1,425.11	108.58	1,533.69	
Measured Water: 5 ml/a	7,125.60	341.96	7,467.56	
etc				

This is a simple build on activity that companies already undertake when setting their charges every year to look at the bill impacts arising from the changes they make. If there are supplementary assumptions, the company would have to set out what these are (for example, some companies have standing charges for different bands of meters – they would have to state what size of meter had been assumed for a given level of consumption).

Indicative charges would supplement the tariff map described above. They would provide both Ofwat and retailers with a likely level of charge for comparison.

¹ Ofgem currently base SMI analysis on standardised consumption of 14,600 kWh of gas and 3,800 kWh of electricity

Problems with a prescriptive approach

We think that it would be wrong for Ofwat to become overly prescriptive in this area. For example, requiring all customers in a category to pay the exact allowed revenue per customer would lead to smaller customers paying more than they should and a potential margin squeeze for the larger customers.

A potential solution to wide variations within bands would be more granular banding, but if anything this would create more problems than it solves. Like most companies, our bands are based on the level of consumption. We do not think we can justify a tariff which varies according to some other criteria like the customer's type of business. But the retail cost to serve customers within each ARC *does* vary considerably. Some customers have high risk of bad debt, pay more slowly, and require a great deal more contact to resolve billing issues.

In a competitive market, the most attractive customers will be those who are low cost to serve. This means that if customers are taken off the default tariff then, over time, the average cost to serve the remaining customers will rise. The smaller the number of customers in each band, the bigger this problem will be.

Example

Within an Average Revenue Control, there are 100 customers:

	Before market opening (when setting ARCs)		After market opening and loss of most attractive customers	
	Cost to serve	Number	Cost to serve	Number
Low cost	£400	50	£400	0
Moderate cost	£500	20	£500	20
High cost	£1000	30	£1000	30
Average cost	£600		£800	

In this example the ARC including margin is set at £600. If the 50 lowest cost to serve customers are removed from this band, the average cost to serve the remainder rises to £800. Bearing in mind that the margin has to cover working capital requirements, this means that the ARC now imposes a margin squeeze on the remaining customers.

Because the wholesale and retail elements of the charge are both controlled, the wholesaler cannot respond to a margin squeeze by cutting prices. If the wholesaler cuts prices by £200, this would not flow through to an increase in the ARC (in fact, it would result in a reduction in the ARC because the bulk of the retailer's margin on sales is a percentage of the wholesale charge).

With broader bands, companies have the flexibility to deal with the loss of a few customers and remain compliant with competition law.

Aside from the real problems that could be created through granular cost allocation, we do not think a prescriptive approach would be in keeping with the type of regulatory model that Ofwat is trying to achieve. Companies have a duty to comply with Competition Law and to avoid undue discrimination between customer groups. In the retail context, this means ensuring that charges are cost reflective, with sufficient margin to enable a competitor to serve that group. However well-intentioned it might be, an approach which constrains companies from complying with their duties is not desirable.

4. 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 think it is reasonable for Ofwat to look carefully at whether the diversity in the *level* of retail charge paid is justified. However, we do not think that any drive towards tariff harmonisation would be justified in the short run.

There will be differences in retail charge between companies and some of these cannot be ironed out without a fundamental change in the framework:

- Ofwat allowed for existing retail costs to be included within charges subject to an efficiency challenge; the average cost per customer differed between companies.
- The net retail margin was set as a percentage of sales. There are very different levels of wholesale charge for different customers across the country. If the allowed margin within retail controls remains 2.5%, then the margin per customer will always be different.

Subject to these constraints, it is reasonable for Ofwat to look at the way that companies have apportioned the overall control across their customers and look for outliers. We think that asking for a standard range of retail charges - similar to the example above - would help to illustrate where these differences lie.

During this review, it is important that there should be a dialogue between Ofwat and companies. Where company allocations are different to the norm, there should be challenge. But we do not think that Ofwat should move from this to prescribing what particular charges should be or the structure of those charges. As the enforcing competition authority, this would place Ofwat in a difficult position if those arrangements were subsequently challenged.

Company Average Revenue Controls are generally based around their existing tariff structures – for example, Severn Trent has bands set at 0, 10 and 50 ml/a, which align with wholesale charges. If ARC bandings were standardised the new bands would cut across these wholesale structures. For example, the creation of a 5-25 ml/a band would straddle two wholesale bands, requiring the creation of 4 new charges for the final customer (0-5, 5-10, 10-25, 25-50). While standard bandings would thus be simpler for retailers, they would create more complexity for the final customer.

In addition, since ARCs span a number of tariffs, standardising those ARCs across companies would offer limited benefit. We believe this would come at a cost to some customers and which would be difficult to justify. Any drive for consistency in structures across companies will inevitably lead to incidence effects and, given that wholesale charges are regional, the bills that customers actually pay will not be aligned.

Consistency in retail charging structures will have limited effect on customers because the majority of the bill is wholesale. This differs because of the underlying network. In some cases structures have been driven by resource considerations (for example, seasonal tariffs), but in most cases it has been driven by company interpretation of charging principles, such as fairness, simplicity and cost reflectivity. Consistency across these charges – which would have a more meaningful effect – would drive even larger bill impacts on customers.

Customers within any region will only experience one set of charges. The different structures in other regions are not relevant to them because they are not available. It would be strange to them if - for the benefit of consistency with a company at the other end of the country - they were asked to pay more. Those customers who benefit are unlikely to contact companies, but those who do not are likely to be dissatisfied.

Consistency between the structure of average retail controls may provide a small benefit to competing retailers, but will do very little for customers and this would come at some cost for them. In our view, dealing with the complexity of multiple company charges is one of the ways in which a retailer should be looking to add value for their customer.

5. 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?

Companies should be able to provide a rationale for the way in which they have allocated costs and margins between customer groups. The industry has a duty to comply with Competition Law and therefore each company should be in a position to show that the charges within each Average Revenue Control are sufficient to cover retail costs.

The table of indicative charges we set out in response to question 3 could be extended for this purpose – for example:

£, 2015/16	Wholesale	Retail	Total	Cost	Margin
Measured Water: 60 m ³ /a	85.52	35.80	121.32	X	X
etc					

There are several different definitions of cost that might be used – for example:

- Ofwat's allowed cost (including efficiency challenge) or company actual cost;

- Cost including working capital (a cost to the company but assumed to be part of Ofwat's allowed margin).

Ofwat would need to define the cost to be used; if this information was to be put into the public domain then allowed (rather than actual) cost would need to be applied. It would be for companies to explain how they had calculated the cost and margin associated with each group.

In practice each company will have a cost allocation model which sits behind these allocations. However, each company will have its own systems, processes and terminology for costs depending on the way the business is structured. We do not think that Ofwat should get involved in examining these disparate models or trying to specify a standard model for cost allocation. The key thing is testing that the outcome of the charges achieves the objective – i.e. sufficient margin to enable competition.

As the consultation suggests, it will also be important to ensure that we engage with our customers to ensure that our proposals are fair and reasonable. We have explained the scope of the review to our Customer Challenge Group. We intend to build on the non-household customer research we undertook for PR14 and will continue to involve our CCG in the development of our proposals.

6. 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?

As noted above, it is up to companies to comply with their duties under the Licence and Competition Law. If a company believes that its existing allocations remain robust, and are satisfied that they complied with all obligations, then the “no change” option – properly justified - must be available.

Companies that opt for no change should be required to provide the same level of information and assurance to Ofwat as those wishing to alter their charges. However, some of the requirements may already have been satisfied by work undertaken at PR14. For example, a company that is not proposing changes should not be obliged to conduct fresh customer research if it has already done so.

We think it is reasonable for Ofwat to challenge these proposals on the basis of newer information and comparison with other companies. But this should not lead to Ofwat imposing a new structure of tariffs or allocations; the obligation to comply rests with companies.

Severn Trent would not intend to take the “no change” option even if it is available. Our experience of access pricing is that allocations are constantly refined and improved and we would therefore expect to take account of newer information in this review.

7. 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 a three year period is the most appropriate period for the control. The only benefit of a different timescale, as we see it, would be that workload on periodic reviews would be staggered. We think this may be desirable in future, perhaps by setting different lengths for the retail and wholesale controls in 2019, but we do not think this would work well in 2016.

A shorter price control is unlikely to be feasible, as the timetable would be extremely challenging. Companies would start preparing for a 2018 review almost as soon as this review is complete. We would be concluding this review at the same time as we are submitting business plans for the remainder of the business, so it would appear to offer only marginal benefits for the profiling of work.

We do not think setting a longer control at this time would be a good option for a number of reasons:

- A Licence change would be required.
- It would be unrealistic to set tariffs beyond 2019/20 without examining the total cost and margin for those years. This would involve a second extension to the scope of the review in that the preferred option is to keep within existing constraints on total retail revenue.
- Re-examining total retail costs beyond 2020 might also involve looking at the boundaries between wholesale, household and non-household, which we believe should be beyond the scope of this review.
- There will be no information on the period after market opening to inform future charges. A great many changes (such as retail exit) may occur after 2016 and we think Ofwat should take stock of these before setting controls that extend into AMP7.
- It is unclear which entities will be accountable for the price control, especially if companies opt to retail exit.

There is a more fundamental point about future NHH retail price controls. By 2020, there is a scenario where the majority (if not all) undertakers have exited their NHH retail businesses to a WSSL. In this scenario the scope and form of the price control would need be thought of in very different terms to the one in contemplation now. Currently WSSLs face less reporting requirements than undertakers and there is no requirement to separately report costs to serve in-area vs out-of-area customers, nor to provide the granularity of cost information in regulatory accounts. The availability of information in 2020 will be more limited and Ofwat will need to re-examine the aim of the price control. Simpler options such as a standardised retail gross margin mark-ups for certain customer groups could be applied across the industry rather than a company specific

price control. There may also be no need to impose price controls on certain customer groups where there is sufficient competition.

8. 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

The Final Determination 2014 proposed a timeline where companies submitted information to Ofwat on 29 July. This has been brought forward to the 15 June, reducing the time available to companies by 1½ months. In itself this is not a problem, but there is very limited time available in between Ofwat's 8th April publication of the statement of method and the submission (2 months).

Ofwat has, rightly, placed great emphasis on Board assurance. There is likely to be only one Board meeting in between the publication of tables and submission. In practice, for Severn Trent this means only 5 to 6 weeks between the method statement and the submission of assured Board papers.

Given this reduction in the time available, we expect that Ofwat will discuss its emerging views with companies in advance of publication, including the detail required for data tables. We would be happy to engage with Ofwat on developing the information requirements and would hope to see a draft view of the tables in advance of 8 April - particularly if these have changed from the tables prepared for PR14. We would also welcome the opportunity to discuss our submission with Ofwat after 15 June; if there are aspects of our proposals that can be clarified then we would not expect this to be the last communication before the Draft Determination.