

United Utilities response to the Ofwat consultation: Review of non-household price controls



Introduction

United Utilities welcomes the opportunity to comment on the Ofwat consultation: Review of non-household price controls.

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 the non-household (NHH) re-opener should only focus only on issues relating to the NHH retail price controls and the default tariff price caps. Please additionally refer to our comments in response to Q2, below.

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?

Remit of the re-opener

We agree that it would seem premature to judge the adequacy of overall costs and margins before PR19.

We are therefore supportive of Ofwat's proposals for this review which were clearly incorporated in Ofwat's final determinations. Deviation from this approach would also represent a significant change in methodology from that set out in final price determinations in December 2014.

Ofwat made a number of statements in PR14 final determinations in relation to the remit of the re-opener, setting clear expectations for the approach that would be followed. For example in section A6.4.3 of "*Final price control determination notice: policy chapter A6 – non-household retail costs and revenues*", Ofwat stated:

"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.

Also, we do not expect the allowed net margin in aggregate across non-household customer types to change from that set out for non-household retail services in our risk and reward guidance. The review will focus only on non-household retail controls and hence will not result in changes to the wholesale and household retail controls included within our final determinations." (emphasis added)

Furthermore, in response to challenges originally raised by UUU in response to the draft determination Ofwat stated (in Table A6.5 of the same document):

"Changing allocations between retail and wholesale would equate to a reopening of the wholesale control. Not only is this currently incompatible with companies' licences, but could have some serious implications for regulatory stability.

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We consider the 2.5% margin to be appropriate in size for companies to manage their competition law risk. Furthermore, any complaints would be made on an individual basis, not on the aggregate 2.5% net margin. Therefore, there will be no case law that will determine the aggregate margin that companies have adopted to be incompatible with competition law.”

Given the strength of these statements - and the clear expectations that they were meant to set – it is perhaps surprising that Ofwat is once again considering the scope of the remit of the re-opener. This is especially so given that Ofwat’s determination of a 2.5% margin was not based on a poorly informed or preliminary analysis; rather, it resulted from a considered view of the appropriate margin based on a broad range of evidence from benchmarking company financial information from competitive retail sectors. It was further informed by evidence provided by companies and a detailed analysis commissioned from PwC. It would seem implausible that sufficient evidence has emerged since Ofwat took these decisions that would cause a reappraisal of them.

Changes to the remit would represent a material change, less than a year after final determinations were issued. Furthermore, it seems difficult to envisage that there is sufficient time for companies to prepare for an expanded remit at this stage of the process, particularly given that Ofwat is also proposing to bring the submission deadline forward by nearly two months compared to its originally published submission date.

In the event that Ofwat considers that the overall level of cost or net margin in its price determination does need to be reviewed prior to 2020, then there would clearly not be any possibility of extending the remit beyond the NHH retail default tariff average revenue controls. As Ofwat itself has recognised, reopening wholesale price controls – whether directly or indirectly (through cost allocations) – is not compatible with companies’ licences and could have serious implications for regulatory stability.

In the event that Ofwat does wish to extend the remit of the reopener to include consideration of the total level of the NHH retail default tariff average revenue controls (whilst by necessity leaving wholesale controls unchanged) then this must be signalled immediately given the impact on companies’ customer engagement and the preparation of our plan in advance of submission in June.

Interaction with deemed contracts

We also note the importance of equivalence in the event of retail exit. We strongly support the principle of equivalence so that customers as far as possible receive the same level of protection whether or not the appointee who currently supplies them decides to exit. This would only seem possible if the default tariff revenue controls are applied, including application of any changes to cost and margin allocations approved as part of the NHH re-opener, regardless of whether the appointee decides to exit.

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

We consider that our default tariff caps already map well to our end user tariffs. If there are general or specific steps which could be made to improve this mapping then we would welcome further exposition of the issues and how they can be appropriately managed.

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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 strongly agree that greater consistency in both default tariff structures and levels would be desirable. It is reasonable to expect that the level of cost and margin allocated to similar groups of customers should be similar between companies.

However, there are a number of difficulties in pursuing this aim.

Firstly, Ofwat has made it clear that companies are accountable for their compliance with competition law when setting prices. Therefore cost reflectivity, not consistency, should be the primary consideration for each company when preparing proposals for any changes to their default tariffs as part of this re-opener.

Secondly, Ofwat must recognise that decisions on pricing proposals are necessarily an individual matter for each company – this is of course not an area where companies could collaborate. In the absence of clear guidance, the attainment of greater consistency relies on all individual companies independently acting the same. We consider that it might be helpful for Ofwat to provide more specific guidance to individual companies for their consideration, to ensure that this aim is interpreted consistently.

Finally, we also note that at the final representation stage of PR14, UuW proposed changes to its default tariff caps which would have had the effect of making them more consistent with those of other companies. These proposals were rejected by Ofwat.

We consider that market opening clearly places the onus on companies to balance its risk of compliance with competition law between different customer groups. Therefore, Ofwat should not place itself in the position of second guessing judgements made by companies in allocating costs and margins. Instead it should only intervene in the event that companies have made material errors in allocation.

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?

Information that companies should provide

We consider that the following should be provided as a minimum

- Evidence that proposed default tariffs reflect an appropriate allocation of costs;
- Evidence that net margins reflect an appropriate allocation of costs and risks;
- Evidence of customer engagement and the support of its CCG in developing the company's proposals for default tariffs; and
- Evidence that the company considers that its methodology for allocating costs and margins is consistent with competition law. We note that "compliance" is only demonstrated following a complaint/investigation, and hence it would not be possible for the company to make an absolute statement claiming that its charges are compliant.

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Information that companies should publish

We consider that the following should be published:

- Proposed average revenue controls by customer group, both cost and margin allocations;
- Comparisons with existing default tariffs revenue controls on a consistent basis;
- Comments received from the relevant CCG; and
- Board assurance statement confirming that any proposed cost and margin re-allocations are revenue neutral.

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, we agree that companies should have this option, and we welcome Ofwat's view that those companies seeking a change will not be treated differently to those that are not.

We strongly believe that the evidential bar should not be disproportionately high for those companies seeking a change in their cost and margin allocations, as appeared to have been the case towards the latter stages of PR14.

A decision taken to not take the opportunity to update cost and margin attributions and allocations through the reopener is an active decision which reaffirms the company's view that its current approach is adequate. It must be viewed as equivalent to a decision to make changes (i.e.: a decision to "stick" is just as active a decision as one to "twist.") Ofwat's consultation indicates that it believes that there should be greater consistency between companies' default tariffs allocations; companies which choose not to make changes at this stage must be prepared to justify their approach in the event of a formal pricing dispute following the reopener.

Consistent with our response to question four, we consider that market opening clearly places the onus on companies to balance their risk of compliance with competition law between different customer groups and the reopener is a key vehicle for ensuring this is the case.

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 agree that three years seems appropriate, and would align with PR19 price controls more widely.

However, we note that Ofwat's draft PR19 timetable states that business plans would be submitted during July/August 2018, which would only allow for one year of evidence following market opening. We suggest that Ofwat considers whether a NHH price control effective from 1 April 2020 could be separated from the remaining PR19 controls such that its business plan would not be required until (say) a year later. This would allow for two full years of evidence following market opening.

It is also as yet unclear whether Ofwat intends to consult on future NHH controls as part of its Water 2020 review, or whether this will be a separate exercise. It is important to specify how this would be applied consistently (or otherwise) to (a) retailers which have exited and are operating under a deemed contract, (b) retailers which have not exited, and (c) new entrant WSLs.

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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?

We strongly disagree with the changes that Ofwat is proposing to make to the timetable at this stage.

We consider that for the re-opener submission to be robust, it would need to:

- Represent 2015-16 actual financial information;
- Allow sufficient time for internal and external governance;
- Allow time for CCG engagement on final submission, and reflection within their letter; and
- Allow time to consider sufficiency of customer engagement, which (necessarily) will have been conducted on prior year actuals and year end estimates.

We do not believe that Ofwat's proposal to bring the submission deadline forward by almost two months to early/mid-June would enable companies to produce plans which satisfactorily meet these needs. We are particularly concerned that there would not be sufficient time to undertake all necessary governance and assurance activities, following any update for 2015-16 actuals, including:

- Obtaining and processing 2015-16 financials;
- Re-calculating proposed default tariff proposals using updated financials;
- Meeting the needs of Ofwat's final methodology and data tables;
- Completing assurance activities on final values used in our submission;
- Applying reasonable levels of internal governance, prior to seeking board approval; and
- Managing any required customer and CCG engagement.

We note that Ofwat does not intend to publish its final methodology and data tables until 8 April - just over 9 weeks prior to business plan submission. This represents around half of the time signalled would be available when the re-opener timetable was published within PR14 final determinations. Such a truncated timetable will increase the risk that company submissions cannot meet the required standards, which could undermine the re-opener process.

We strongly urge Ofwat to re-consider its need for more time to review company submissions. Rather, Ofwat should seek to ensure that requirements and expectations are clarified in advance to reduce the risk of incomplete, or non-compliant company submissions which subsequently require more work to be undertaken by Ofwat staff. For example, earlier publication of required data tables, along with any minimum evidential requirements for cost/margin allocations and assurance would help to ensure that company re-opener submissions do not place an undue burden on Ofwat. Furthermore, any late additions to requirements (i.e. any requirements not signalled in this consultation, and subsequently added to the final methodology) will likely be very challenging to deliver.

In the event that Ofwat does change the timetable as it has proposed, it should recognise that the proximity of the submission deadline to company year ends will by necessity impact the ability of the company to provide full and final assurance and reconciliations to full year figures. To resolve this issue in a proportionate manner, and recognising that the scope of the reopener is only likely to reflect the distribution of margin within the overall NHH retail price control envelope, Ofwat should only require a draft submission of financial reconciliations in June, based on unaudited (but close to final) versions of year end accounts. This could then be followed by a final submission with a full reconciliation to the final published accounts later in the summer, based on the final year end position.