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Dear Cathryn

Consultation on the review of non-household retail price controls

Thank you for the opportunity to respond to this consultation.

We have common interest in a successful and timely opening of the market, and with this in mind our key concerns are timetable and cost reflectivity.

Timetable

We think it would be helpful for you to publish:

- your methodology and information requirements for this review by February
- draft determinations ahead of shadow operation in August, and
- final determinations by October 2016.

This revised timetable will allow:

- new entrant retailers to develop their offerings in advance of market opening
- incumbents sufficient time to develop well-grounded proposals taking full account of engagement with their customers and Boards, and
- incumbents time to complete their charges governance processes for publication of the 2017-18 charges rates in January 2017.

Cost Reflectivity

Board ownership of company proposals will require them to take into account the investment that they will already have approved to enable retail market readiness, as well as new knowledge of the ongoing costs of compliant retail operation within the market. It is reasonable to expect that incumbent costs in 2017-18 will be greater in cash terms than those incurred in 2013-14.



It is unlikely therefore that company Boards, particularly those such as ours which at PR14 were at the industry efficiency frontier, will be able to own proposals that are tied to the overall cost envelope determined at PR14.

While we note that you expect incumbent retailers' costs to be reduced by consolidation in the market our joint venture retail arrangements with Bristol Water were developed in advance of 2013-14. The efficiencies created by this explain our low cost to serve and are therefore already baked into our PR14 determination.

We have answered your consultation questions in the attached appendix.

I hope this is helpful and, as ever, would be very happy to answer any further questions that may arise.

Very best wishes,

Andy

Andy Pymer
Director of Regulation & Customer Services

Responses to consultation questions

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

The PR14 Final Determination had a price control for Households - as defined in section A5.4, appendix 5 of "Setting Price Controls for 2015-20" (July 2013) as follows:

Households: These are properties used as single domestic dwellings (normally occupied), receiving water for domestic purposes which are not factories, offices or commercial premises. These include cases where a single aggregate bill is issued to cover separate dwellings having individual standing charges. (In some instances the standing charge may be zero). The number of dwellings attracting an individual standing charge and not the number of bills should be counted. Exclude mixed/commercial properties and multiple household properties, for example, blocks of flats having only one standing charge.

The current price control for non-households is defined as covering all premises that are not households under the definition above.

Since the FD Ofwat has published eligibility criteria for competition. We are currently finalising our market eligible dataset, but our current view is that ~20,000 (i.e. ~20%) of premises attributed to the PR14 non-household price control will not be eligible to switch retailer – the great majority of these are multiple dwellings supplied through a single meter.

It would be helpful for Ofwat to clarify the treatment of such premises, this could be:

- they remain in the retail non-household price control and retain default tariff protection, or
- they are transferred to the household price control and are subject to the ACTS allowances.

Our preference would be that they remain in the retail non-household price control, but that the margins attributed to these customers should be in-line with those allowed in the household control, recognising that there is no competition risk. This means that:

- the retail household control is unaffected
- companies can take into account the specific cost characteristics of these customers in charges - which can be materially different to single households, particularly where the bill-payer benefits from limited liability through the Companies Act.
- these customers do not pay inappropriately for the opening of the market

We note that for PR14 revenue allowances to remain whole the 2.5% average allowed margin (if it remains at 2.5%) will need to be calculated inclusive of the 1.0% margin attributed to customers not eligible 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?

Companies will now have far greater visibility and understanding of their ongoing costs post 2017 than they did at PR14 and will by now have confirmed their investment plans to achieve market readiness and level playing field compliance.

Board ownership of company proposals will require them to take into account the investment that Boards will already have approved to enable retail market readiness, as well as new knowledge of the ongoing costs of compliant retail operation within the market.

We note that the consultation document implies that Ofwat expects all incumbent retailers to be impacted by further consolidation in the market - our joint venture retail arrangements with Bristol Water were developed in advance of 2013-14 and the efficiencies created by this are therefore already baked into our efficient cost to serve in the PR14 determination.

It is unlikely that company Boards, particularly those such as ours which at PR14 were at the efficiency frontier, will be able to own proposals that are tied to the overall cost envelope determined at PR14.

The current proposals do not therefore surmount to companies providing a business plan. As the proposals stand, we will provide a business plan to Ofwat that recovers our costs, allows the non-household retail business to finance its functions with Board assurance.

We could alongside this provide a submission which is fully consistent with Ofwat's final published guidance but it is unlikely that we will be able to recommend to the Board that this can be assured as complying with all our obligations.

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

Our end-user charges including default tariffs map exactly onto our wholesale charges (i.e. they are structured and presented in the same way) allowing a customer or retailer to easily calculate the charges and revenue from the retail services based on their use of the services provided. This is to allow other retailers to easily understand where margins may exist for them to exploit, and for customers to understand the cost of the service they receive.

Ofwat could therefore require all incumbent companies to structure their wholesale and end-user tariffs (incorporating default tariffs) in the same manner to increase transparency.

While it may be superficially attractive to impose a single flat retail charge + margin on all customers within a default tariff band, doing so:

- reduces the ability of an incumbent company to comply with its obligations
- does not in reality increase transparency for customers/retailers compared to the approach we have taken of structuring wholesale and end-user tariffs in the same way
- will reduce trust and confidence in the sector by leading to incidence effects that results from a reduction in cost reflectivity, rather than an improvement to it.

The non-household retail price control sets an average cost per customer plus a margin to be recovered from each customer group. Companies must translate these “default tariffs” into actual tariffs, making the charge for each customer as cost reflective as possible to comply with their obligations.

Some retail costs are driven by the level of the wholesale bill which is primarily volume driven – therefore cost reflectivity at the customer level requires some of the retail charge to vary by volume used. Because of this variable charge component, the amount recovered by companies will vary from customer to customer based on their usage or RV. This means that customers in the same group will pay different amounts, but on average the company will recover the correct revenue. We suspect that it is a lack of understanding of this point that has led some to complain about transparency 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

It is important that end tariffs are easy for customers to understand. However, this must be balanced against the need for default tariffs to reflect the service levels, cost to serve and relative efficiency of each company, and to minimise incidence effects for customers. Therefore we think that, in order for companies to provide adequate assurance they are complying with all of their obligations, they should be free to allocate their costs and margins according to their requirements. As per our answer to question 3, Ofwat could require companies to structure and present their end-user (including default tariffs) and wholesale charges in the same way.

We do see one area where it would be possible to increase consistency relatively easily and provide a benefit to customers and market participants – the volume bands for the default tariff caps. Ofwat could specify the bands which companies should provide tariffs for. Companies could use these bands to give a more detailed approach or they could choose to amalgamate the bands to give a simpler approach. The resulting default tariff caps would then be more comparable and easier for customers and competing retailers to understand.

Using Ofwat’s useful analysis in Appendix B of the consultation, we have assessed where the majority of companies have already chosen to band tariff caps by volume, and

where large differences in cost and margin occur signifying differing levels of service, cost to serve and risk. Based on the above, we propose the following bands:

- 0-1 MI
- 1-5 MI
- 5-10 MI
- 10-50 MI
- 50-250 MI
- >250 MI

If Ofwat proposes new volume bands (or other rules) for companies to use in their submissions, it must give them sufficient time to complete analysis to ensure changes to tariffs are cost reflective and engage appropriately with customers and their Boards. Therefore Ofwat should publish its final methodology in February 2016 (as per our answer to Q8).

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 think that Ofwat's proposals in this area (including customer engagement, assurance etc.) could be considered proportionate if we were to undertake a full review of costs and default tariffs.

However given that Ofwat is minded to require companies simply to reallocate the current revenue allowances set at PR14 we think that the requirements for the current proposals for a default tariff reallocation exercise with no other changes are inappropriate and impose an undue regulatory burden.

The customer research we undertook on default tariffs in 2014 was a useful exercise to understand customers' views on what was an appropriate customer group to use as a default tariff. As a result of the research we decided to postpone higher default tariffs for mixed-use customers (due to the increased bad debt risk) until market opening so those customers have an opportunity to switch suppliers if they choose.

However we found that asking customers' views on cost reflectivity and the relative costs of different tariffs was not a valuable exercise as customers naturally assumed we would be charging on a cost reflective basis as a principle. Given the engagement we have already carried out in this area, we consider that requiring additional customer research merely to ask whether tariffs should be cost reflective or not is unnecessary regulatory burden.

As detailed in our response to Q2, we think that it is unlikely that the Board can provide assurance of compliance with obligations under a review that does not allow the non-household retail company to recover its costs. Board assurance is therefore not appropriate in this context.

Notwithstanding this, in the event that Ofwat decides to require companies to remain within the PR14 default tariff allowances at an aggregate level Ofwat needs to clarify the

source of this when it confirms its methodology (at the latest in February 2016) - for instance should it be built bottom-up from latest forecasts of wholesale revenues per customer group? Or more simply should we take the aggregate amounts assumed in table A5.2 of our FD document? Given that cost reflectivity at the aggregate level would already be compromised by our inability to take into account our latest cost estimates we would prefer a more simple approach.

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 believe that we should fully update the required cost and margin allocations to provide cost-reflective default tariffs that are competition law compliant and allow the non-household retail business to finance its functions. We will take the most up-to-date information into account when doing this and we expect Ofwat to determine appropriately.

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.

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 do not agree.

We think it would be helpful for you to publish:

- your methodology and information requirements for this review by February
- draft determinations ahead of shadow operation in August, and
- final determinations by October 2016.

This revised timetable will allow:

- New entrant retailers to develop their offerings in advance of market opening
- Allow incumbents sufficient time to develop well-grounded proposals taking full account of engagement with their customers and Boards
- Allow incumbents time to complete their charges governance processes in time for publication of the 2017-18 charges rates in January 2017.

This review will set the default tariffs at market opening and in the early development of the non-household retail market. Therefore it is important that the available time is maximised to allow companies and Ofwat to perform their respective duties to the best of their abilities. This will ensure trust and confidence in the market among customers and market participants in its formative years. With this in mind, we make the following recommendations.

We think that the publication of the final methodology in April is late and unnecessarily pressurises later steps – the experience of PR14 demonstrated the need to start as early as possible. We do not think that a 4 month period from the closing of this consultation is necessary to formulate a final methodology. Publication in February would give more time for both companies to formulate plans, engage with Boards and customers as appropriate, and Ofwat to review them.

We also think that the proposed final determination is too late and doesn't give new retailers information early enough to prepare for market opening, nor incumbent companies to set customer charges (based on Ofwat's process for setting 2016-17 charges).