

South East Water
Business Retail
Price Review 2016

July 2016

OVERVIEW

This document sets out South East Water's submission for the 2016 Business Retail Price Review.

Attached to this submission is the Ofwat data table.

Any queries in relation to this document should be sent to:

Oliver Martin
Head of Economic Regulation and Strategy
South East Water, Rocfort Road, Snodland, Kent, ME6 5AH
01634 873050
Oliver.Martin@southeastwater.co.uk

1 OUR APPROACH

1.1 KEY STEPS

To develop our updated default tariff submission for 2017/18 to 2019/20 we have followed the following key steps:

- Update tariff bands / groups
- Update for 2015/16 costs and allocation drivers
- Update customer numbers
- Generate 2016/17 to 2019/20 cost forecast
- Update assumptions for wholesale revenue component
- Margin allocation

The details for each of these steps are outlined below.

1.2 UPDATE TARIFF BANDS / GROUPS

In our Final Determination we had the following tariff bands for our default tariffs:

- Unmetered water
- 0 – 5 MLa water
- 5 – 10 MLa water
- 10 – 50 MLa water
- 50 – 250 MLa water
- Over 250 MLa water

We have reviewed these tariff bands to ensure they are consistent with the proposed bands as specified in Ofwat's Business Retail Price Review 2016 methodology. No changes were needed for this.

We have however taken the opportunity to split the 0-5 MLa band into two. We now propose to have a band for 0-2.5MLa and a band for 2.5-5 MLa. The reason for this is that the retail

cost to serve customers in these two new bands are different as customers move from a 6-monthly meter read and bill frequency to a monthly read/bill profile when they use above 2.5Mla. We have therefore made this change to improve the cost reflectivity of the retail cost component of our default tariffs.

1.3 UPDATE FOR 2015/16 COSTS AND ALLOCATION DRIVERS

In generating the cost base for our submission we have used our latest 2015/16 accounting separation cost information.

We have reviewed the cost allocation drivers used in our PR14 submission and updated these so they are in line with the allocation drivers used in our 2015/16 statutory/regulatory accounts. The cost drivers are consistent with Ofwat’s minimum requirements for cost allocation and in two cases we have adopted drivers that we consider to be more cost reflective than the minimum requirements.

A summary of relevant allocation drivers for retail are shown below:

Expenditure type	Allocation driver
Billing	Number of bills raised
Payment handling	Number of payments received
Non-network and network customer enquiries and complaints	Volume of enquiries
Investigatory visit / first visit to customer	Volume of enquiries
Meter Reading	Number of meter reads
Other customer services	Customer numbers
Debt management, doubtful debts and disconnections	Directly attributable to bad debt
Demand side water efficiency initiatives and customer side leaks	Customer numbers
Other operating expenditure	Customer numbers

Overall this does not increase the average retail cost per customer for 2017/18 as demonstrated in the Ofwat data sheet outputs shown in Section 2.

There is a marginal cost increase in 2018/19 and 2019/20 which is discussed in Section 1.5.

1.4 UPDATE CUSTOMER NUMBERS

We have updated our customer numbers to be in line with our latest forecast figures. This takes into consideration two main factors:

- Reduction in eligible premises for competition – as part of our eligibility assessments in relation to the opening of the non-household market we have identified a number of premises that are classified as household.

- Reduction in void properties – void properties are not billed for retail costs and do not use any consumption. They have therefore been removed from the total count of customers.

The changes, as applied to the customer numbers for 2017/18, are shown below.

Customer numbers for 2017/18	
Customer numbers – PR14	58,183
Reduction in eligible premises	1,777
Reduction in void properties	4,787
Customer numbers – PR16	52,119

Note: there is likely to be some cross-over between the properties that have been removed due to the change in the number of voids and the change in the number of properties due to the eligibility cleansing undertaken in order to prepare for market opening (eg a property that is both in-eligible and void). Where this is the case they are shown in the void properties line in the table above.

The change in customer numbers in 2018/19 and 2019/20 is due to forecast new connections in both years of 254 properties.

1.5 GENERATE 2016/17 TO 2019/20 COST FORECAST

To forecast retail costs for the period 2016/17 to 2019/20 we have applied the average level of cost driver per customer in each tariff band for 2015/16 to the forecast number of customers (properties) for each of the years.

This approach therefore assumes that the average level of cost drivers per customer in each tariff band remains the same over time.

1.6 UPDATE ASSUMPTIONS FOR WHOLESALE REVENUE COMPONENT

To ensure our assumptions for the wholesale revenue component are up to date we have based these on our forecast used for our 2016/17 charging model.

We have analysed the percentage of wholesale revenue (and therefore consumption) that we have forecast to be billed to non-household customers in 2016/17 and used this as a start point for our wholesale revenue in this submission. We have then adjusted this to allow for the new connections included in our property forecast.

1.7 MARGIN ALLOCATION

We have continued to apply a methodology for allocating the net margin between the tariff bands based on the core drivers of risk and return. These drivers are: return on capital employed, return on working capital, bad debt risk and a residual component that reflects other risks, tax and a margin for competition.

2 OUTPUT

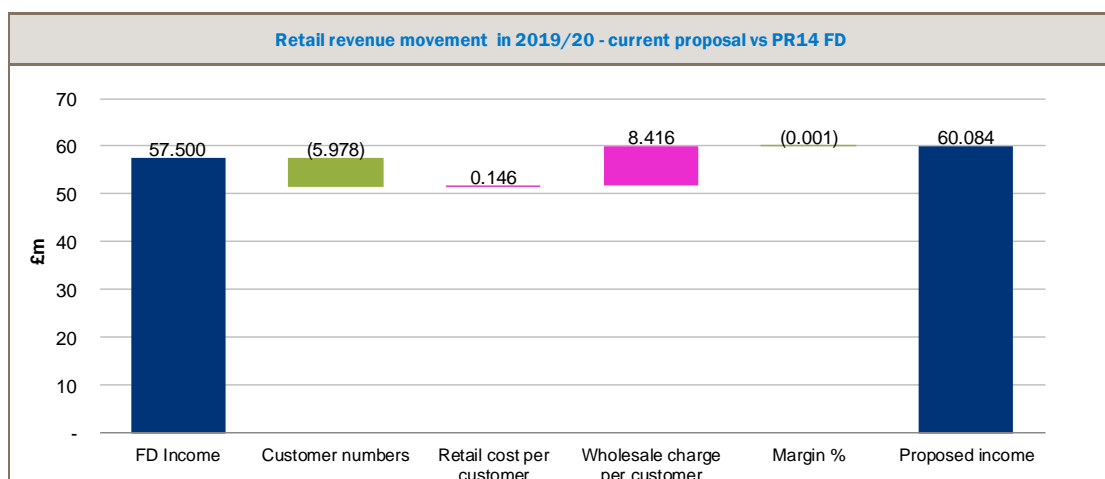
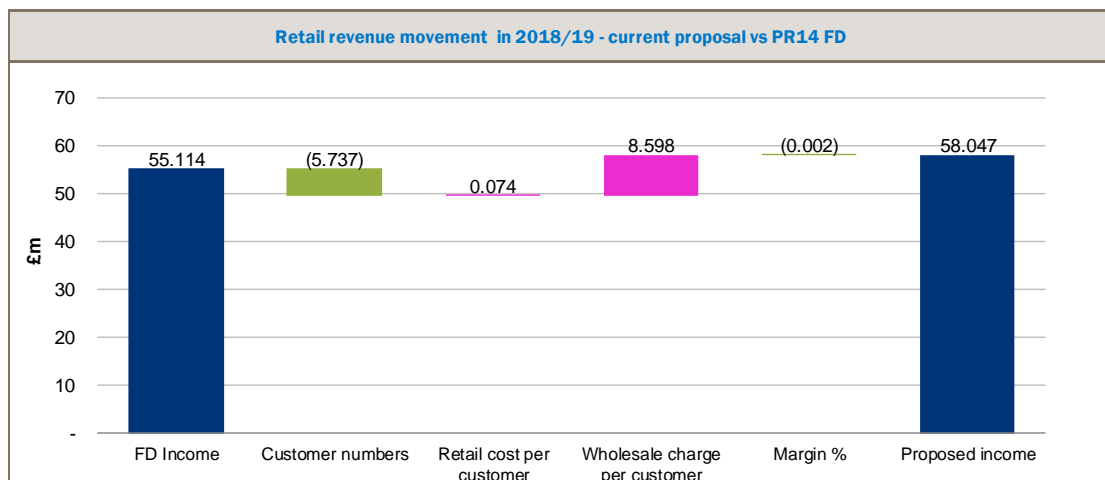
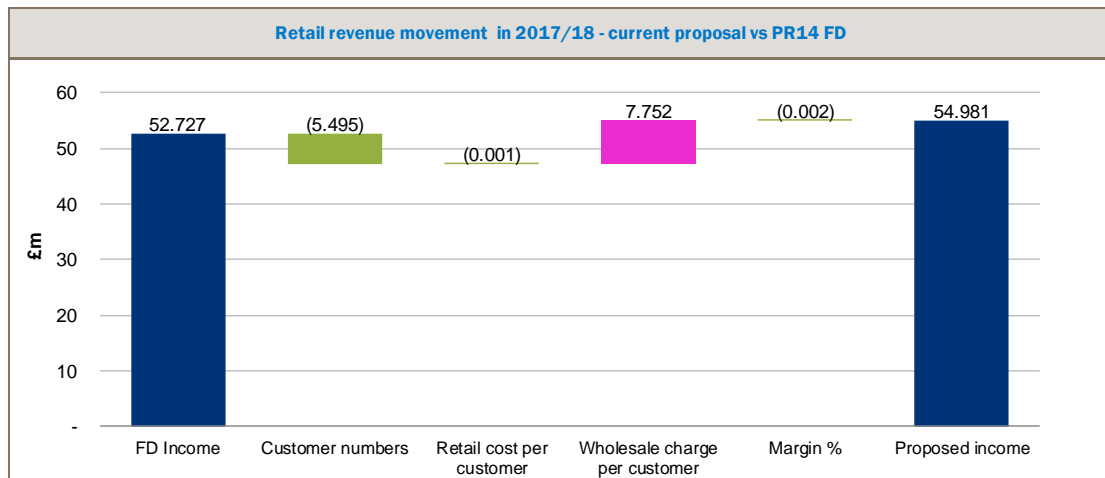
2.1 OFWAT DATA SHEET - TABLES

The following table shows the output sheet from the Ofwat model.

Output Summary		South East Water														
Overview	Units	Final Determination at PR14					Current Proposal PR16					Change				
		2015-16	2016-17	2017-18	2018-19	2019-20	2015-16	2016-17	2017-18	2018-19	2019-20	2015-16	2016-17	2017-18	2018-19	2019-20
Number of tariff bands	number	6	6	6	6	6	6	6	7	7	7	-	-	1	1	1
Number of customers	number	57,631	57,907	58,183	58,458	58,733	57,631	57,907	52,119	52,373	52,627	-	-	(6,064)	(6,085)	(6,106)
Retail net margin	£m	1.224	1.276	1.320	1.379	1.439	1.224	1.276	1.375	1.451	1.502	-	-	0.055	0.072	0.064
Retail costs	£m	2.262	2.224	2.179	2.129	2.087	2.262	2.224	1.951	1.980	2.012	-	-	(0.228)	(0.149)	(0.075)
Retail gross margin	£m	3.485	3.500	3.499	3.508	3.525	3.485	3.500	3.325	3.431	3.514	-	-	(0.173)	(0.077)	(0.011)
Wholesale charge	£m	45.410	47.462	49.228	51.606	53.975	45.410	47.462	51.656	54.617	56.570	-	-	2.428	3.011	2.595
Total retail revenue	£m	48.895	50.961	52.727	55.114	57.500	48.895	50.961	54.981	58.047	60.084	-	-	2.255	2.933	2.583
Retail margin as % of total retail revenue	%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	0.00%	0.00%	0.00%	0.00%	0.00%
Retail gross margin as % of wholesale charge	%	7.68%	7.37%	7.11%	6.80%	6.53%	7.68%	7.37%	6.44%	6.28%	6.21%	0.00%	0.00%	-0.67%	-0.52%	-0.32%
Retail cost per customer	£	39.24	38.41	37.45	36.41	35.53	39.24	38.41	37.43	37.80	38.23	-	-	(0.02)	1.39	2.70
Wholesale charge per customer	£	788	820	846	883	919	788	820	991	1,043	1,075	-	-	145.02	160.05	155.93

2.2 OFWAT DATA SHEET - GRAPHS

The following graphs are taken from the output sheet in the Ofwat model.



2.3 COMMENTARY ON GRAPHS

The graphs show the movement on the proposed level of retail non-household revenue for each year. Each of the movements on the bar chart are explained below:

- Customer numbers – reflective of the reduced revenue due to a reduction in non-household customer numbers. Note the graph assumes that all properties are consuming water however the removal of the 4,787 void properties would all be at a zero consumption. This consumption is therefore ‘added back’ in the wholesale charge per customer column.
- Retail cost per customers – this shows the minimal impact of refreshing our retail costs to be in line with our 2015/16 regulatory/statutory accounts.
- Wholesale charge per customers – this apparent increase is due to the voids property movement discussed above, and an increase in forecast consumption attributed to non-household properties.
- Margin % - this shows a very minimal change due to rounding. The total net margin remains at 2.5%.

3 BILL IMPACTS

The following table shows the bill impacts for our proposed submission.

Customer type	2017/18	2018/19	2019/20
Water - Unmetered	1.5%	1.6%	1.7%
Water - Metered 0-2.5 MI/a	(0.3%)	(0.1%)	0.1%
Water - Metered 2.5-5 MI/a	0.5%	0.5%	0.5%
Water - Metered 5-10 MI/a	0.2%	0.2%	0.2%
Water - Metered 10-50 MI/a	0.1%	0.1%	0.1%
Water - 50-250 MI/a	(0.2%)	(0.2%)	(0.1%)
Water - Metered 250+ MI/a	0.0%	0.0%	0.0%

The bill impacts shown above are due to changes made to cost allocations and margin.

4 ASSURANCE

4.1 INTERNAL ASSURANCE

To ensure the information and data we have provided in this submission is robust we have undertaken a range of internal assurance in line with the assurance levels set out in our Company Monitoring Framework. This is summarised below:

Assurance level	Level description	Activity description
Level 1	Peer review, manager review and approval	<ul style="list-style-type: none">▪ Tariff model, methodology, inputs, outputs and submission checked and approved by Manager
Level 2	Internal and external audits/assurance	<ul style="list-style-type: none">▪ Tariff model, methodology, inputs, outputs and submission checked and approved by Head of Department▪ External assurance of the methodology and model and completed by Frontier Economics▪ Submission reviewed and approved by Regulated Strategy Group
Level 3	Board and Executive review and approval	<ul style="list-style-type: none">▪ Submission reviewed and approved by Executive Team▪ Submission reviewed and approved by Board

4.2 INDEPENDENT ASSURANCE

In producing our Business Retail Price Review submission we have obtained external independent assurance from Frontier Economics.

The principle objectives of the assurance were to answer the following questions.

- Do South East Water's proposed non-household retail tariffs comply with Ofwat's methodology for PR16?
- Do South East Water's proposed non-household retail tariffs appropriately reflect the principles of competition law?

4.3 INDEPENDENT ASSURANCE FINDINGS

Frontier Economics have produced us a detailed assurance report which concludes as follows:

"Overall we find that South East Water's approach to determining non-household retail default tariffs is reasonable. We find that the approach taken by South East Water to allocate costs and margins to the default tariffs is appropriately evidence based, and reasonable. We provide below a summary of our conclusions.

- The allocation of costs, both for 2015/16 costs and PR16 costs, uses appropriate drivers, and the approach to estimate future levels of cost drivers is reasonable. The margin allocation is appropriately evidence based and appears reasonable.
- Our view therefore is that the resulting approach is consistent with competition law principles, in particular the proposed default tariffs are also consistent with licence condition E.
- In addition, the consistent application of these default tariffs by South East Water in our view would not be inconsistent with the company's obligations under condition R, which requires it to show no undue discrimination between its customers and those of other licensed water suppliers.
- To the extent that charging scheme rules issued by Ofwat under section 143B of the Water Industry Act 1991 are relevant here, we consider that South East Water's approach is consistent with those particular rules.
- Further, we have not identified any issues with the way that the outputs from South East Water's workings have been transposed in to the Ofwat data tables.
- Finally, we note that South East Water's proposed default tariffs are not inconsistent with the level of the uniform caps for medium and large users that Ofwat has indicated it is likely to use at PR16."

5 STAKEHOLDER ENGAGEMENT

During June and July we met with representatives of our Customer Panel (Chair and Business Customer representative) and the Consumer Council for Water to discuss our Business Retail Price Review submission.

We explained the approach we have adopted in producing our submission and discussed the bill impacts as shown in Section 3.

Further to these discussions and a small number of clarification questions South East Water can confirm that no outstanding issues remain.

6 BOARD ASSURANCE STATEMENT

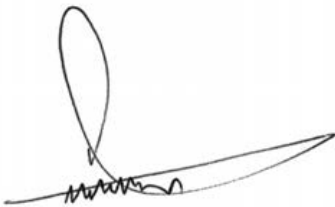
For the preparation of this statement we have considered compliance with our statutory, regulatory and licence obligations relating more particularly to setting charges and price controls.

The internal and external governance processes that we have followed, in line with our Company Monitoring Framework, have not identified any deviation from or non-compliance with these obligations and to the best of the Board's knowledge after reasonable enquiries the company has complied in all material respects with these obligations.

Based on the scope and outcome of the process detailed in this submission and the engagement with the Customer Council for Water and our Customer Panel the Board is able to confirm that:

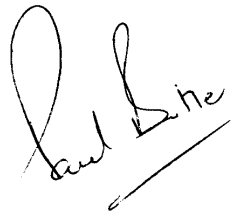
- The information provided is consistent with the Company's legal obligations (including, where relevant, the prohibitions on undue discrimination or preference in licence condition E and licence condition R, and the charging scheme rules issued by Ofwat under section 143B of the Water Industry Act 1991) and competition law.
- Where appropriate the Company's proposals have been reasonably informed by customer engagement, and research and discussion with the CCG.
- The allocation and attribution of costs and margins to revised or new default tariff caps are reasonable and robust (with costs and margins attributed by appropriate drivers and activities, and the proportion of costs subject to broader allocation rules kept to the minimum that is reasonably practicable).
- Data tables have been completed accurately and consistent with any guidance that Ofwat has provided.

Nick Salmon, Chairman



.....

Paul Butler, Managing Director



.....