Business retail price review 2016

Southern Water's Submission

July 2016

Contents

Assurance statement

The Company, under the direction of the Board, has undertaken a thorough process of internal and external assurance with regard to this submission in response to Ofwat's business retail price review 2016. As a result of the assurances it has received, the Board has satisfied itself to the best of its ability that:

- the information we have provided is consistent with our 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;
- there are no material bill incidence effects arising from our submission;
- subject to recognising the increase in eligible customers, the original allocations and attributions that informed the PR14 final determinations remain reasonable; and
- data tables have been completed accurately and consistent with any guidance that Ofwat have provided.

Matthew Wright

Chief Executive Officer

1.0 Overview

Headlines:

- Our submitted data tables highlight a material increase in the number of eligible premises compared to our business plan submission.
- Outside of the restructuring associated with the uniform tariff bands, we have not revised the allocations of retail costs, net margin, and wholesale charge between default tariff bands.

The increase in the number of eligible premises has resulted in a transfer of retail costs, net margin, and wholesale charge from the household retail price control to the non-household retail price control. The additional premises fall within our unmetered and 0-1 Ml bands, and our analysis has concluded that it is reasonable to assume that they attract the same level of retail cost and wholesale charge as premises already assigned to those bands. This approach was shared and discussed with Ofwat at our meeting on 9 June 2016.

The table below summarises the movement in eligible premises between 2014-15 (as set out in our PR14 business plan submission) and 2017-18 (as set out in our Business retail price review 2016 submission). The table also reflects the change to uniform tariff bands.

<table>
<tr><th>Service/tariff band</th><th>2014-15</th><th>2017-18</th><th>Change</th></tr>
<tr><td colspan="4">Water</td></tr>
<tr><td>Unmetered</td><td>4,750</td><td>5,715</td><td>965</td></tr>
<tr><td>0-1 Ml</td><td>50,924</td><td>58,782</td><td>7,858</td></tr>
<tr><td>1-5 Ml</td><td>4,593</td><td>4,593</td><td>0</td></tr>
<tr><td>5-20 Ml</td><td>837</td><td rowspan="2">1,091</td><td rowspan="3">0</td></tr>
<tr><td>20-100 Ml</td><td>285</td></tr>
<tr><td>100+ Ml</td><td>13</td><td>43</td></tr>
<tr><td colspan="4">Sewerage</td></tr>
<tr><td>Unmetered</td><td>10,259</td><td>11,694</td><td>1,435</td></tr>
<tr><td>0-1 Ml</td><td>73,298</td><td>84,009</td><td>10,711</td></tr>
<tr><td>1-5 Ml</td><td>6,895</td><td>6,895</td><td>0</td></tr>
<tr><td>5-20 Ml</td><td>1,094</td><td rowspan="2">1,390</td><td rowspan="3">0</td></tr>
<tr><td>20-100 Ml</td><td>337</td></tr>
<tr><td>100+ Ml</td><td>14</td><td>54</td></tr>
<tr><td colspan="4">Trade effluent*</td></tr>
<tr><td>Billed annually</td><td>685</td><td>n/a</td><td>n/a</td></tr>
<tr><td>Billed quarterly or monthly</td><td>202</td><td>n/a</td><td>n/a</td></tr>
</table>

* Note: in 2014-15 trade effluent customers also featured in the sewerage customer count

The increase in eligible premises has arisen, in the main, from our data cleansing work in preparation for the opening of the non-household retail market in April 2017. Under this work, we have re-classified premises using a variety of tools and data sources, both internal and external. Changes in Ofwat's eligibility guidance made since our PR14 business plan submission has also been a contributory factor behind the increase in eligible premises.

Ofwat are now requiring companies to adopt common tariff bands above the 5 Ml threshold. The default tariff structure we developed for PR14 included a band with a volume threshold of 5Ml, and another band spanning the volume range of 20 to 100 Ml. Therefore, the new uniform bands that have been put in place under the 2016 review have not necessitated a reallocation of retail costs, net margin, and wholesale charge at the 5 Ml threshold. However, we have needed to undertake such a reallocation for the 20-100 Ml band. Furthermore, in response to Ofwat's direction to combine the sewerage and trade effluent bands above the 5 Ml threshold, we have decided to do make this simplification below the 5 Ml threshold as well.

The table below illustrates the impact of the new uniform bands and consolidation of the sewerage and trade effluent bands on our default tariff structure. The PR16 figures in the table also reflect the final adjustments made to ensure overall compliance with the 2.5% net margin. The table compares the average retail costs and net margins included in our submission, with the figures submitted for PR14. For the purpose of this illustration, data for 2017-18 has been used. The data for 2018-19 and 2019-20 has a similar pattern.

PR14 Tariff Band	PR14 average retail cost £	PR14 net margin %	PR16 Tariff Band	PR16 average retail cost £	PR16 net margin %
Water					
Unmetered	12.29	2.22	Unmetered	12.29	2.16
0-1 Ml	23.30	6.48	0-1 Ml	23.30	6.30
1-5 Ml	81.43	2.90	1-5 Ml	81.43	2.83
5-20 Ml	201.87	2.46	5-50 Ml	220.82	2.21
20-100 Ml	320.85	1.38			
100+ Ml	1,922.16	0.65	50+ Ml	1,008.37	0.66
Sewerage					
Unmetered	15.14	2.00	Unmetered	15.14	1.95
0-1 Ml	25.44	3.70	0-1 Ml	25.48	3.62
1-5 Ml	96.05	2.06	1-5 Ml	98.39	1.98
5-20 Ml	248.36	1.84	5-50 Ml	332.01	1.54
20-100 Ml	508.10	1.63			
100+ Ml	1,984.10	0.55	50+ Ml	1,822.04	0.66
Trade Effluent					
Billed annually	48.28	0.61			
Billed >annually	380.55	0.45			

From the table it is clear that customers with a volume of 50 Ml would, potentially, experience the highest increase in retail charges. However, taking the level of their wholesale charges into account, the increase in their total charge would be under 3%. Furthermore, for 2017-18 we are planning to introduce a graduated retail tariff structure that sits beneath each default tariff cap. This will help manage the transition from the current default tariff cap structure to the new structure.

In accordance with our discussions with Ofwat on 9 June 2016, the average retail costs, percentage net margins, and wholesale charge remain at PR14 levels, with two qualifications:

i. There are minor changes to the sewerage bands arising from the absorption of the trade effluent bands.
ii. There are proportional minor adjustments to the net margins for all bands to ensure overall compliance with the 2.5% net margin.

The increase in eligible customers, and our overall approach to this submission, is discussed in more detail in the sections below.

As attachments to this document, we provide our completed data tables and an accompanying a line commentary in Microsoft Excel format.

If there any queries regarding our submission please send these to Paul Graham paul.graham@southernwater.co.uk (01903 272573).

2.0 Increase in eligible premises

2.1 Background

Prior to the coming into effect of the new price controls on 1 April 2015, we did not operate separate tariff structures for household and non-household premises.

Because both classes of premise were subject to the same tariff structure, the correct classification of premises was not essential to the correct application of our tariff structure and the calculation of our charges.

Until our billing system was upgraded in August 2014, the description held against each premise record in the system was not based on externally-accredited information. For the vast majority of premises, the premise description was based on the value migrated from the legacy billing system in 2007. For properties built before 1990, these values in turn would have been based on the description provided by the Valuation Office under the general rating system prevailing at that time. For properties built after 1990, these values would have been provided from sources such as property developers, water distribution staff and contractors, and inset water companies where we only provide sewerage services.

In anticipation of the implementation of separate retail price controls and the opening of the NHH retail market, the August 2014 billing system upgrade included the building of an interface that allowed us to receive address and premise description data from the Ordnance Survey AddressBase Premium product. We used this data, which we continue to receive on a regular basis, to validate and improve the premise address and description data held in our billing system. In preparation for the implementation of the new price controls on 1 April 2015, we used the premise description data from the Ordnance Survey to identify premises subject to the retail non-household price control, based on the Ofwat eligibility guidance prevailing at that time. It was on this basis that we selected the premises to transfer to our new default tariff structure with effect from 1 April 2015.

However, at the time that we were undertaking this exercise, there were a significant number of premise records in our billing system that had not been successfully address-matched to the Ordnance Survey data set. Because our new non-household tariffs were higher than our household tariffs (reflecting the recovery of the allowed costs of market opening), we adopted a cautious approach and kept premises on the household tariff structure where there was uncertainty regarding the correct classification of the premise.

2.2 Review of eligible premises

Since implementing our default tariff structure on 1 April 2015, we have worked to reduce the number of records unmatched with the Ordnance Survey data set, and Ofwat have revised their eligibility guidance a number of times in preparation for the opening of the retail non-household market in April 2017.

As part of our preparations for market opening, we have undertaken a comprehensive review of eligibility for our premise data set. Firstly, we used a flag held within the Ordnance Survey data set to establish whether the premise attracted business rates, council tax, both, or neither. This exercise identified groups of premises that required further investigation to determine eligibility; for example to establish the principal use of the premises, and to identify instances of dependency. In addition to using premise and customer data already held in our billing system, we used a variety of in-house and on-line tools and data sources to establish eligibility for these premises. For the cases where determining eligibility has been more challenging, our auditors, PwC, have performed independent checks and provided feedback.

Compared to the position when we implemented our default tariffs in April 2015, this review of eligibility has identified some 16,400 premises that are eligible and some 2,400 premises are not eligible; a net increase in eligible premises of some 14,000. Some 7,800 of these premises receive our water supply services, and some 11,200 receive our wastewater services[1].

Our analysis of the premises newly identified as eligible as a result of our review indicates that over 90% have a residential or unclassified premise description assigned from the Ordnance Survey data set. As explained in section 2.1, when we implemented our default tariffs in April 2015 we adopted a cautious approach and classified these premises as household, taking the Ordnance Survey classification at face-value. However, our review of eligibility in preparation for market opening, as outlined above, identified these premises as requiring further investigation, and based on the application of Ofwat's revised eligibility guidance we have now determined them to be eligible.

[1] We would note that the draft figures presented to Ofwat at our meeting on 9 June 2016 did not include the impact of deducting premises that were not eligible, as we were not able to quantify these at the time. The figures in this submission also reflect further work that we have undertaken on eligibility in the four weeks following our meeting with Ofwat.

3.0 Our approach

3.1 Introduction

In responding to this review, our starting position is that we remain satisfied with the allocation of retail costs, net margin, and wholesale charge that we performed for PR14. This position is supported by the findings of an external review of our default tariff structure that we commissioned earlier this year. This review, undertaken by Economic Insight, concluded that:

- Our banded default tariff structure based on volume is supported by a correlation between volume and the cost-drivers.
- Our default tariffs provide customer protection and therefore meet the primary regulatory objective.
- The design of our default tariffs would not be expected to create material barriers to entry, so there is no strong case for changing our allocation of the net margin across the customer groups.
- The methodology we used to allocate non-household retail costs across customer groups was consistent with Ofwat guidance.
- Our default tariffs have been constructed in a way that limits the risk of a margin squeeze occurring compared to a more ad hoc approach to pricing.

Economic Insight's review suggested there may be a case for refinement within our 0-1 Ml band, but this can be achieved by adjustments to the tariffs that sit beneath the cap rather than by restructuring the cap itself. We therefore have not made structural changes to this tariff band.

3.2 Impact of the 2016 price review

The price review has resulted in us making three changes to the default tariff structure that we developed for PR14:

1. Incorporating the increase in eligible customers arising from our data cleansing work and changes in Ofwat's eligibility guidance.
2. Restructuring the tariff bands above 5 Ml to comply with the two new uniform bands.
3. Combining our sewerage and trade effluent tariff bands.

Each of these changes is discussed in more detail below.

3.2.1 Increase in eligible customers

If this price review hadn't taken place, we recognise that the normal operation of the two retail price controls would have automatically adjusted revenues in 2017-18 to reflect the transfer of customers from the household to the non-household control.

Our submission under this price review requires us to reflect the increase in eligible customers. In order to ensure there is no loss of revenue and price distortion, our submission also needs to include a commensurate increase in the allowed level of non-household retail costs, the overall allowed level of net margin (in financial terms), and the overall allowed level of wholesale charge.

We have reviewed our household/non-household retail cost allocation, which was scored as exceptional by Ofwat in their PR14 risk-based review. For each area of retail cost, this allocation was based on variable cost-drivers, meaning that the required level of retail costs is directly linked to the number of customers. We have therefore concluded that, within individual tariff bands, it would be reasonable to assume that the additional non-household customers attract the average level of non-household retail cost as established at PR14.

With regard to the wholesale charge, we have compared the average annual volume of a large sample of the anticipated additional customers with the average volumes established at PR14. The results of our sampling exercise are set out in the table below.

	Sample average m3/a	**PR14 average m3/a**
Water	**164**	**155**
Sewerage	**160**	**163**

On the basis of our sampling, we have concluded it would be reasonable to assume that the additional non-household customers attract the same level of wholesale charge as established for customers in the unmetered and 0-1 Ml tariffs bands at PR14.

Setting aside the impact of combining our sewerage and trade effluent tariff bands and complying with the overall net margin of 2.5%, which are discussed in sections 3.2.3 and 3.2.4 respectively, our proposed approach for handling the increase in eligible customers results in the following outcomes:

- no increases in the per customer retail cost allowances within bands;
- no increases in the percentage net margins within bands;
- no increases in the per customer wholesale charge within bands; and
- within the non-household retail price control overall, no revision to the allocations of retail costs, net margin and wholesale charge between tariff bands.

The approach outlined above was shared and discussed with Ofwat at our meeting on 9 June.

3.2.2 Restructuring the tariffs bands above 5Ml

Above the 5 Ml threshold, the structure we developed for PR14 comprised three tariff bands for each of the water and sewerage services: 5-20 Ml, 20-100 Ml, 100+ Ml. Ofwat's statement of method has required us to restructure the bands above the 5 Ml threshold into two uniform bands: 5-50 Ml, 50+ Ml. This required us to reallocate the retail costs, net margin, and wholesale charge for our 20-100 Ml band. The underlying cost allocation modelling and volume data that supported our PR14 submission included separate volume bands for 20 to 50 Ml and 50 to 100 Ml, allowing us to perform this reallocation without re-running the original analysis.

Again, setting aside the impact of combining our sewerage and trade effluent tariff bands and complying with the overall net margin of 2.5%, which are discussed in sections 3.2.3

and 3.2.4 respectively, we would confirm that, in aggregate, this restructure results in no change to the level of retail costs, net margin, and wholesale charge from the allocations made for the bands above 5 Ml at PR14.

3.2.3 Combining our sewerage and trade effluent tariff bands

In response to Ofwat's direction to combine the sewerage and trade effluent bands above the 5 Ml threshold, we have decided to make this simplification below the 5 Ml threshold as well.

This exercise entailed the reallocation of c£110k of trade effluent retail costs and c£9m of trade effluent wholesale charge across the full range of metered sewerage tariff bands.

The absorption of the trade effluent bands has resulted in minor changes to the average retail costs set at PR14. The table below sets out the impacts on the sewerage bands, before the impact of the increase in eligible customers, and before the final adjustments to comply with the overall net margin of 2.5%. For the purpose of this illustration, data for 2017-18 has been used. The data for 2018-19 and 2019-20 has a similar pattern.

<table>
<tr><th>PR14 Tariff Band</th><th>PR14 average retail cost £</th><th>PR16 Tariff Band</th><th>PR16 average retail cost £</th></tr>
<tr><td colspan="4">Sewerage</td></tr>
<tr><td>Unmetered</td><td>15.14</td><td>Unmetered</td><td>15.14</td></tr>
<tr><td>0-1 Ml</td><td>25.44</td><td>0-1 Ml</td><td>25.48</td></tr>
<tr><td>1-5 Ml</td><td>96.05</td><td>1-5 Ml</td><td>98.39</td></tr>
<tr><td>5-20 Ml</td><td>248.36</td><td>5-50 Ml</td><td>332.01</td></tr>
<tr><td>20-100 Ml</td><td>508.10</td><td rowspan="5">50+ Ml</td><td rowspan="5">1,822.04</td></tr>
<tr><td>100+ Ml</td><td>1,984.10</td></tr>
<tr><td colspan="2">Trade effluent</td></tr>
<tr><td>Billed annually</td><td>48.28</td></tr>
<tr><td>Billed >annually</td><td>380.55</td></tr>
</table>

3.2.4 Complying with the overall 2.5% net margin

Having made the adjustments for the increase in eligible customers, the creation of the uniform bands above the 5 Ml threshold, and the combining of the sewerage and trade effluent tariff bands, the final adjustment was to ensure compliance with the overall net margin of 2.5%.

Without adjustment, the increase in retail costs and wholesale charge arising from the increase in eligible customers would result in a c£90k/pa over-recovery against the overall net margin of 2.5%. Therefore, in accordance with the approach we discussed at our meeting with Ofwat on 9 June 2016, the net margins for all bands have been subject to a minor adjustment to ensure compliance. To make this adjustment, we calculated the value of the scaling factor required in each year to reduce the overall net margin to 2.5%. The value of the scaling factor was close to 98% for all years, reflecting the minor nature of this adjustment (i.e., a circa 2% adjustment of the 2.5% net margin, equating to a reduction in bills of less than 0.05%). The value of the scaling factor for each year was applied consistently to all bands.

The table below sets out the impacts of the final adjustment to ensure compliance with the overall 2.5% net margin. For the purpose of this illustration, data for 2017-18 has been used. The data for 2018-19 and 2019-20 has a similar pattern.

Tariff band Ml	**Water net margin pre-final adjustment %**	**Water net margin post-final adjustment %**	**Sewerage net margin pre-final adjustment %**	**Sewerage net margin post-final adjustment %**
Unmetered	2.21	2.16	2.00	1.95
0-1	6.44	6.30	3.71	3.62
1-5	2.90	2.83	2.02	1.98
5-50	2.26	2.21	1.57	1.54
50+	0.68	0.66	0.67	0.66

4.0 Assurance

Throughout the duration of the review to date, starting with Ofwat's consultation in late 2015, our Customer Advisory Panel, Executive Management Team and Board have been briefed and kept updated on developments. At their meeting in June 2016, the Board were briefed on and approved the approach and outcomes set out in this submission.

The Board have also approved the wording of the assurance statement that prefaces this document.

As discussed above, we commissioned Economic Insight to undertake a review of the default tariff structure we put in place at PR14 (section 3.1), and commissioned PwC to undertake eligibility checks for the most challenging cases (section 2.2).

The detailed calculations that support the inputs to the submitted data tables have been reviewed by the responsible senior manager, the Head of Economics and Strategy.

Inputs to the submitted data tables have been checked for accuracy and appropriateness back to supporting sources by our auditors, Deloitte, in accordance with agreed-upon procedures. We have received their formal assurance in respect of this work.

With the July meeting of our Board falling after the submission deadline, our Board delegated authority to our Chief Executive Officer to sign the assurance statement and authorise the making of the submission to Ofwat.

Based on the assurance work carried out, in particular the outcome of the specific piece of work carried out by Deloitte in July 2016, our Chief Executive was able to sign to assurance statement that prefaces this document.