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Dear Rachel

Incumbent water companies and the development of effective markets

The recent letters from you and Emma Kelso come at an important time in the sector as we face challenges from climate change to changing customer expectations. In order to meet these it is critical that we continue to find more effective ways of providing services. In this context we strongly support the emphasis on innovation and markets in the recent Ofwat strategy.

At Severn Trent we have been strongly supportive of Ofwat's efforts to promote the use of markets in the water sector. We have championed the expansion of competition to areas of the value chain to deliver real benefits for customers, such as the trading of water resources and bioresources, and we actively supported the establishment of non-household retail market opening in 2017 (including by forming the Water Plus joint venture with United Utilities in 2016).

In this context we take our responsibilities as an incumbent provider of water and wastewater services, including under Competition Law, very seriously. This involves considering very carefully the impacts that our decisions can have on other actual and potential market participants including in what are often nascent markets. In part, this is addressed through the systems and processes that our Audit Committee has in place to provide assurance that our charges comply with legal and regulatory obligations. However, we are acutely aware that non-price factors can influence competitive conditions in a range of ways, and put considerable effort into engaging with retailers and competing providers of services that we offer (including self-lay providers (SLPs) and new appointments (NAVs)) in order to seek to better understand and proactively address identified problems.

We also recognise that to support the development of these markets it's important that we constantly engage with our customers, from retailers, NAVs and businesses (consuming wholesale services) to ensure we learn from them and continually improve. We actively use a wide variety of tools to try to improve our understanding of customers' experiences. This includes specific forums such as the market performance committee (non-household retail), our biannual self-lay forums and developer days alongside our insight tools such as Qualtrix, Sprinklr (social media scraping) and bespoke research (eg through business retailers and developer focus groups). We provide some examples of how we have used the insights gained from these tools below and in the Appendix to this letter.

I hope that our attached response conveys the supportive, proactive and constructive way in which we have consistently sought to engage in the opening and effective ongoing operation of markets in the sector. We continuously seek to review and improve our practices, and are keen to identify and draw on learning opportunities that may arise as part of this review.

The appendix to this letter deals with the more detailed questions in Emma Kelso's letter of 16 September, but I touch on a few key issues below.

Our Board's support for the development of effective markets

Our Board sets the strategic direction for the company and the Severn Trent Executive Committee (STEC) oversees the development and execution of Severn Trent's strategy, including accountability for business results. STEC's duties include periodic review of business unit performance reports in light of the Group's strategy and to approve policy guidelines for business units based on the approved strategy and budgets.

One of the five strategic objectives that our Board has set since 2015 is *Change the market for the better*. As our Board has consistently set out (including in our Annual Reports), that means: 'We'll embrace market opening in the UK and explore opportunities for growth in new water markets'. In line with this, our commitment to promoting markets is longstanding and firmly embedded. For example, we established our Wholesale Market Unit (WMU) in 2016 to provide a primary focus for Retailer and MOSL interactions and to proactively support development of the new non-household retail market. In addition to weekly and monthly performance management reviews by the Head of WMU, performance is reviewed at an Executive level via a number of routes to ensure alignment to the company strategy in support of effective markets, with corrective actions instigated where necessary.

Business retail market

We chose to exit the retail market but Severn Trent Plc retains an interest in Water Plus. We take our responsibilities under competition law very seriously – we recognise that we have an obligation to operate at arm's length with all retailers.

Credit terms for retailers

Credit is a key issue for retailers and it is understandable that they would like to see improved terms. It is important to remember that when non-household retail was separated out, the costs associated with bad debt and credit management were allocated to retail. The main risk that retailers bear is customer credit, and the allowed margin should reflect this.

Although there is no allowance within wholesale costs for bad debt or credit management, we voluntarily introduced an arrangement providing free credit for all up to £125,000. This exposes the wholesale business to an element of risk that is not reflected within our allowed revenue. We believe this demonstrates our commitment to the development of effective markets as the measure was very much targeted at new entrants that may have more limited credit facilities. In other cases the available credit terms are defined by the Market Codes and all retailers have the same options; we are very conscious of our duty to ensure that we operate a

level playing field for all. The appendix provides further detail in response to the more specific questions in Emma Kelso's letter.

When the market was set up Ofwat explored the options for a true-up mechanism for bad debt arising from the failure of a retailer but chose not to pursue it at that time. If an *effective* correction was introduced, it would be reasonable for wholesalers to extend more credit. However, this would need to operate outside the regular mechanism for interim determinations: the failure of a retailer would not be sufficient to trigger a determination by itself and – more importantly – any costs arising from a regulatory solution should not be borne by household customers who are not eligible for competition.

Metering services

At present we do not offer a meter reading service. While the offer of a wholesaler service could be helpful to small retailers that may struggle with reading a handful of meters dispersed across the country, set against this is the problem with demonstrating that any service is provided at arm's length. We are actively considering our approach in this area, and recognise that there are other ways that we can help retailers to improve meter reading in the market; we detail some of the steps we are taking in the appendix.

Improving wholesale performance

We recognise that Severn Trent's performance has not been where we would want it to be. We have a strong ongoing focus on performance improvement with clear action plans in place to address this; which are delivering improvement. We achieved our best-ever operational performance standards in the second quarter of this year moving us above the industry average; and following our improvement in market performance standards we were pleased, in August, MOSL closed two of our Initial Performance Rectification Plans – and we achieved target on the one remaining plan last month. We are an active member of industry groups seeking to drive best practice. We know that greater harmonisation of charges and policies would help retailers and we are working through the issues involved, particularly where there is an impact on customers.

Developer services

Self-lay providers (SLPs) are largely interested in operating within the new mains requisitions market and they have commanded a (minimum) 50% share of this market for the past few years in the Severn Trent region, we believe we are working in a way that enables them to compete, secure schemes and grow their businesses.

Robust and fair charges based on incurred costs

Our charges are based on our directly incurred costs of providing developer services activity and we assure our charge calculations against this principle. Much of the activity is delivered by our third party contractor with rates agreed through a formal competitive tender, which should ensure that our charges sit within the market range.

Asset payments paid by Severn Trent are set at 90% of total mains construction costs - the highest in the market - and we are therefore confident that this enables SLPs to make suitable margin. This percentage payment makes our charges predictable and mirrors the approach we take when calculating the income offset for sites we connect ourselves.

Customer service and consultation

We knew that we needed to improve our service to SLPs, and we believe we have risen to that challenge. We restructured our teams by customer segment a number of years ago (self-lay providers; small developers and builders; larger developers and NAVs); we think we now have a clear and fair offer for all. Our service is evolving so we established a bi-annual self-lay forum where we consult SLPs on many topics from day-to-day practices and relationships through to the code of practice and charges.

We believe this has forged open relationships, maintained through regular conversations with our self-lay team. We were pleased to achieve an upper quartile outcome in the most recent DMeX pilot undertaken in late 2018, and previously we delivered consistent upper quartile performance in the Water UK Levels of Service Performance metrics. There are obviously occasions when our SLPs raise concerns, but our collaborative approach ensures we are aware and can address them. This dialogue has shaped our approach to charging in a way that goes beyond simple compliance with Charging Rules and which promotes effective competition for contestable work. For example, we published a 'self-serve estimator' tool, making it easier for SLPs and developers to predict their costs and asset payments in direct response to customer feedback.

New Appointments and Variations

Severn Trent was the first company to introduce a bespoke tariff for NAVs, published in October 2016 - this was before Ofwat launched its most recent review of policy in this area. We worked with Frontier Economics ahead of its report to Ofwat which recommended a wholesale-minus tariff along the lines that we had already implemented.

Customer service

Following the introduction of the tariff, we saw a significant increase in NAV enquiries. Ofwat had assessed the two NAV sites already operating in our area as viable based on standard commercial rates and the new approach materially improved the available margin. We recognised that our response to NAVs was not as prompt as it could be - often following the lines a developer enquiry would take - and now provide a more tailored service. Since then three new NAVs have begun operating in the Severn Trent area and the operators are looking at other sites. We believe this demonstrates we are working in a way that enables NAVs to compete.

Actions to improve our offering to NAVs

This year we have undertaken a full review of our bulk supply charges to ensure that they are compliant with Ofwat guidance and to take account of feedback from NAVs. We worked with Frontier Economics on our model and approach to charging.

The original NAV charge was based on a company funding its own infrastructure through the bulk supply discount. Given that the rules around the income offset have changed, we have updated the NAV charge to take account of the new approach in AMP7. Working with Frontier, we've also undertaken a full review of the costing and approach to deriving the NAV tariff.

Our original approach was to calculate a standard rate for a typical housing development. This produced a simple, predictable charge which could be published in advance. We said that where the costs of any site were materially different from norm (for example, because of pumping) then we would take these into account. We've now published a calculator on our website which enables NAVs to estimate the discount for any site. To further improve the customer offering, we have also brought together all guidance for NAVs into one convenient document.

Effective support for new markets

Our *Changing course* publications over the last ten years demonstrate how we have been early advocates in promoting markets - showing sector leading thought in these emerging markets.

Practical steps in water trading

The idea of water trading is not a new concept to us - we made offers to Anglian to trade water using Birmingham ground water via the Trent several years ago when they were short, and have also discussed with them reversing the trade at the works in the south of our patch.

We are open to third party supplies where they are more cost effective than solutions we could develop ourselves. We have purchased or signed contracts for a total of 98Ml/day of water since 2016 and are in negotiations to purchase a further 27Ml/day. We're also working collaboratively with United Utilities and Thames Water to develop a major supply scheme for the water stressed south east of England (the Severn to Thames transfer). In developing our Water Resources Plan we think we gave full consideration to the alternatives, but we acknowledge Ofwat's feedback on our Bid Assessment Framework and have revised this in line the recommendations.

We are already trading in the bioresources market

Imports from UU and Yorkshire are being treated at some of our works. At present these are spot trades, but we're hopeful that other companies will enter into a longer-term framework in the near future.

We were early advocates of sludge trading in our *Changing course* publications and we see this as a potential win for both the exporting and importing companies. The key will be to ensure that excess capacity can be used to reduce costs, while ensuring that pricing remains compliant with our obligations under RAG5 and Competition Law. As this is a new area, we are keen to work with Ofwat to make sure that the evolving approach in bioresources works for the long-term benefit of customers.

I hope this allays the concerns contained within your letter if indeed any of those concerns related to Severn Trent. We have responded to the specific questions in Emma Kelso's subsequent letter in the appendix.

Kind regards



Liv Garfield