

Draft statement of method for review of non-household retail price controls

Severn Trent response

We strongly support Ofwat's proposal to simplify the non-household revenue controls and believe that there is a pressing need to do so.

At the start of PR14 it was not clear how the non-household price control would operate. Companies were asked to put forward retail costs for serving different groups of customers; each of these costs became a binding constraint on pricing. The result was that the smallest revenue control became the most complex – in our case, 18 controls on less than 2% of our revenue. In our view, this does not meet Ofwat's objective of targeted and proportionate regulation.

Non-household retail controls should concentrate on the customers most in need of protection when the market opens. We therefore welcome Ofwat's proposal to focus regulation on small customers. More limited, generic controls on gross margins make sense for larger users who are likely to take advantage of competition when the market opens.

Controls for large customers should be seen very much as a back-stop protection, and a precursor to deregulating these charges. Prior to AMP6, charges for customers using more than 50 Ml/a were not subject to formal controls; even sites using more than 1 Ml/a represent the top 12% of our customer base. We think it unlikely that many of these customers will remain on regulated retail tariffs by 2020.

If caps for larger customers are a back-stop, then they should be set at a relatively high level. Where these are higher than a company's proposals, that company should not be required to reduce small customer charges because of higher limits that it may not intend to use. It is important to remember that any additional margin on large users under default caps is somewhat theoretical – these customers will not stay on the default rates so companies will never earn that margin. If companies price up to the limit with larger customers in the year of market opening, they do so at their own risk. We would not support uniform caps if this meant a requirement to reduce our small customer retail charges, which would increase our risk of imposing a margin squeeze.

We would encourage Ofwat to set the boundary between small and large customers at a slightly higher level – 5 Ml/a. Consumption for individual customers is volatile year on year: At 1 Ml/a there will be thousands of customers who will move across this boundary each year (and thus move between controls). At 5 Ml/a the churn between controls would be reduced to hundreds of customers, and the administrative burden for both companies and regulator would be significantly reduced. We also think that if Ofwat implements this change, it will be important to establish some tolerance within the control so that companies are able to comply without fear of breaching their Licence.

If you would like to discuss any aspect of this response further, please do not hesitate to contact myself or a member of my team.



Yours sincerely

A handwritten signature in black ink that reads 'A J Ball'.

Dr Tony Ballance
Director of Strategy and Regulation

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Response to individual questions

Q1 We welcome views on our assessment of NHH retail cost to serve and the initial conclusion that an adjustment to the overall level of NHH retail cost allowances is not required.

We do not think it is realistic for customer bills to increase in 2017/18 to facilitate larger margins. With this constraint, higher margins for non-household could only be achieved through a reallocation of revenue from one of the other controls and we do not think that option is available. The Wholesale and Household Retail controls are due to run until 2020 and there is no basis for re-opening them at this point.

Ofwat has noted some evidence that retail costs may be higher in the energy sector and possibly also in the Scotland, where water retailers already operate in a competitive market. Average non-household retail costs have also increased in England and Wales, but we agree that it is too soon to know what will happen when the retail market opens. We think that companies will gain a better understanding of non-household retail costs in the new environment once the market has been in operation for two years – by the time of the next periodic review.

Companies will be working towards PR19 as soon as the market opens – this is early enough to consider how the new arrangements are working and to reappraise what costs and margins should be included within each control. At this point we think that Ofwat should reconsider whether marketing and acquisition costs should be allowed within non-household controls. When opening retail markets it has been common for regulators to allow for the costs of competition, and it will be important to set retail revenues at a level that does not impose a margin squeeze on competitors. Following market opening there will also be evidence for the scale of these costs in England.

We do consider that retail allowances might need to alter to take account of changes in eligibility. These changes could not have been known to companies when putting forward plans in 2014 and therefore some adjustment may be necessary, as we discuss in response to question 6.

Q2 We welcome views on our assessment of net margins and the initial conclusion that a 2.5% net margin remains appropriate.

The new retail market aims to deliver competition for the benefit of customers. Given that the wholesale and household retail controls are not being re-opened, Ofwat could only allow for higher net margins at this point by increasing customer prices. It would be difficult to see how this promoted the customer interest, particularly given the CMA's findings on appropriate retail margins and returns in the energy sector.

In advance of market opening, we think there is insufficient evidence to suggest that the 2.5% net margin is too low to allow for effective competition. We think Ofwat should look again at retail allowances at PR19, to see whether market participants are able to earn the expected level of margins given the additional costs that they bear in a competitive environment.

Q3 We welcome views on whether there are sufficient difficulties and complexities associated with the present arrangements to justify simplifying the form of the control by introducing uniform caps on the NHH gross margins for larger sites.

We strongly support the proposal to simplify the non-household revenue controls and believe that there is a pressing need to do so.

At PR14, companies were asked to put forward proposals for average non-household retail tariffs. Most based these around their existing tariff structures. These generally offer lower rates to large customers – particularly those using more than 50 megalitres of water per year. Discounts are based on reduced network costs when providing a service to large customers; the boundary points were not established with a view to providing customer protection, as the largest customers have been able to choose an alternative supplier under different forms of competition for some time.

The form of control adopted at PR14 meant that when companies put forward average costs for serving a group of customers – differentiating their customer base – these costs became binding constraints on pricing.

In Severn Trent's case, the results were that:

- We moved from a single price control to 21 binding revenue controls.
- 18 of these relate to non-household retail which comprises just 1.7% of our overall revenue.
- The tightest controls now relate to bills for the largest customer which were previously outside price controls.

The number of controls around non-household retail pricing appears disproportionate. The controls are also misdirected – it is small customers that are probably most in need of protection in the new retail market, but in Severn Trent's case the highest degree of control is around retail pricing for around 200 huge water customers that will almost certainly negotiate new contracts as soon as the market opens.

Complications with the proposed approach

Introduction of new charges

While we support the aim of simplifying the non-household control, some aspects of Ofwat's proposal will introduce greater complexity. The Ofwat consultation states that Ofwat is not aiming to impose consistent charging on companies as a result of this review. Nonetheless, there will be consequences for the way that company charges are structured.

Severn Trent does not currently operate a band for 0-1 MI/a (or our suggested level of 5 MI/a). In order to comply with a revenue control at either of these thresholds we would need to differentiate charges above and below this level – it is practically impossible to use a single set of charges which recovers the right average level of revenue from two different groups. This is something that we would deal with, but Ofwat should recognise that the form of the control does have real consequences for customer bills (we introduced new fixed charges specifically to deal with our 18 non-household retail controls this year).

Compliance with controls

Compared to our current bands at 10 and 50 MI/a, banding at 1 MI/a means an exponential change in the number of customers who will be at or near the boundary. We have around 1,300 customers using more than

10 MI/a, with customers near the boundary moving both ways in any given year. We had around 24,000 customers using between 500m³ and 2,000m³ last year and so the number that might flip between controls will be much higher. This creates two issues:

- Administrative: at the start of the year a customer will have been put on tariffs assuming they will pay at one rate, but will have to be switched to another. There will need to be a reconciliation based on the volume they have actually used.
- Compliance: the company will have set tariffs based on the assumption that the revenues associated a set of customers belong to one control, and find that they have moved to another. In spite of using central estimates and best endeavours, the company may have breached one of its controls.

Example: In a charging year, a company assumes it will have 20,000 customers using between 1 and 50 MI/a and sets its charges accordingly. At year end it finds that 1,000 of these have used only 900m³ each. Although this is less than expected, it is considerably higher than the average for the lower control (which is around 500m³ per property). The additional properties in the 0-1 MI/a control means that the average revenue per customer now exceeds the control.

The first issue is simply a problem for companies to deal with; the latter is a potential problem with the form of control. Non-Household income is currently governed by a series of average revenue controls. Each is a binding constraint and – technically – collecting more than the allowed average in any one of them is a breach of the control.

We propose two solutions in order to deal with these issues. The first is to move the threshold from 1MI/a to 5MI/a. There are several precedents for using this as the cut-off between small and medium customers; for example, it is the threshold that was previously used in the Water Supply Licensing regime. The small end of the uniform controls as proposed would pick up customers using 1 MI/a, paying combined bills under £3,000 per year. Moving to a 5 MI/a threshold would substantially reduce customer churn between bands – from thousands to possibly 1-200 customers in our region each year.

Secondly, we think Ofwat needs to recognise that we set charges that aim to recover the right amount from each of these controls, but these are based on forecast numbers of properties and volumes. Forecasts are almost guaranteed to be wrong; despite best endeavours companies will over or under-recover on all non-household retail controls. For wholesale and household retail, Ofwat established mechanisms to deal with this problem, but for non-household no such approach has been put in place. We think if Ofwat is reconsidering the non-household controls, it should also look at how to ensure that companies are able to comply with it.

Our favoured approach would be for Ofwat to adopt a simple true-up at PR19 for the customers subject to non-household controls in each year, the same as for household retail. Based on information that companies supply in the regulatory accounts, Ofwat would simply calculate the difference between the revenue that a company has collected and what ought to have been recovered (that is, the gross margin per customer on actual customer numbers and wholesale revenue). This should be assessed at an aggregate level for all non-household revenue on regulated tariffs. As we note above, customers will move between bands because individual consumption is volatile, so detailed checking and explanation of the revenue differences in each band should not be required.



By PR19, many customers on regulated tariffs will no longer be supplied by incumbents as a result of retail exit. Customers still protected by retail controls will need to enjoy the same level of protection as those of existing companies. All retailers need to be licensed by Ofwat and Ofwat will continue to set revenue controls for these customers beyond 2020 if it deems this necessary. Therefore we do not see retail exit as an obstacle to this type of mechanism.

Form of control for small customers

Allowed costs and margins

We agree that Ofwat should set “bespoke” controls for each company in order to remain consistent with the PR14 determination. This should be set based on the costs allowed at PR14 and the net margins allocated to small customers. A uniform control for all bands, across the whole industry, would not be appropriate as it would radically change the allowances under the revenue control. There is a wide difference between standard wholesale tariffs across the industry and therefore a uniform percentage for all customers would make some customers – and regions – much more profitable than others because of the underlying wholesale charges. The retailer would simply earn rent on wholesale assets, rather than a charge which reflects the cost of activity.

A uniform control on larger customers may be reasonable if it is viewed as a back-stop protection (and therefore unlikely to be the basis for actual retail prices). Controlled tariffs are very likely to be the norm for small customers for some time, depending on the level of activity in the market.

Gross or net margin

If Ofwat adopts a gross margin approach for all large customers, we think that applying a different type of control – cost plus net margin – to smaller users would represent an unnecessary complication. We therefore think that the bespoke cost plus net margin should then be converted to a percentage gross margin for each remaining year of the control.

Number of controls

In our view, this approach should leave water and sewerage companies with 6 non-household controls if it is implemented:

Severn Trent View	Ofwat Proposal	Water	Waste
0-5 MI/a	(0-1 MI/a)	X	X
1-50 MI/a	(1-50 MI/a)	X	X
50+ MI/a		X	X

We do not think that a separate control for unmeasured customers is necessary; these users should be included within the 0-5 (0-1) MI/a blocks for each service. Almost all non-households are metered and where they are not this is because it is impractical or extremely costly to do so. This typically happens where a property has number of sub-divisions that are difficult to meter such as offices or workshops that share floor space within a building. The average consumption for residual unmeasured properties is well below the 1,000m³ threshold and we believe that these customers should have the same level of protection as metered customers within this size band.



A separate control for special agreements is also unnecessary, in our view. We have legacy special agreements with a diverse range of customers, ranging from household levels of consumption to huge customers using or discharging hundreds of megalitres per year. Assigning a single average retail cost to this group is a poor fit and it would be more sensible to include them within other categories. The difference from regular customers is that the end user charges (and form of customer charges) is controlled by law or contract such that any retail margin has to be created through a wholesale discount. This is an issue for companies to manage.

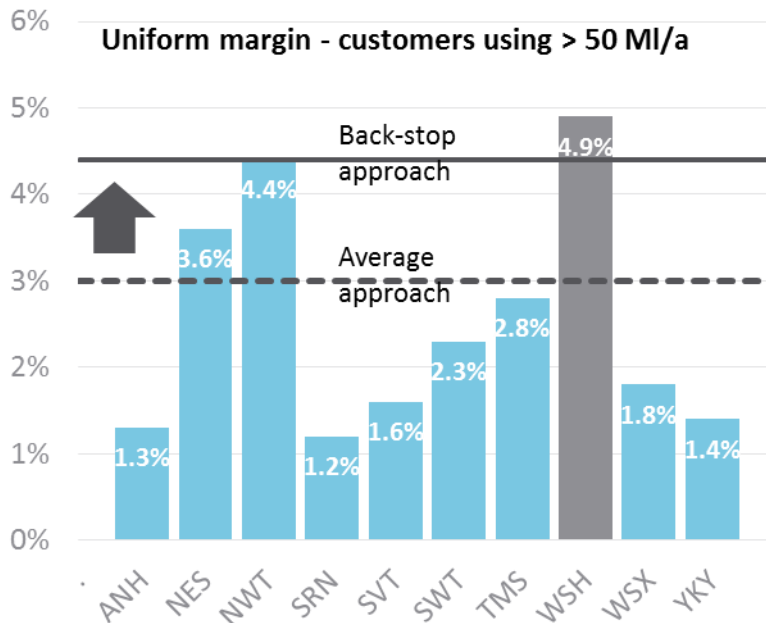
Fewer average revenue controls will not mean that companies stop differentiating their retail charges. Companies still have an obligation to comply with competition law; in order to avoid a challenge they must set charges that reflect the retail cost of providing a service to each class of customer. So, in our case, the merging of bands would not mean that we would charge the same to measured and unmeasured customers because the cost of retail service are different. In our view the question is the size at which customers need protection.

Non-household retail is the smallest segment of company income, and would still have the largest number of controls even if this change is implemented. This reinforces the need for Ofwat to take a proportionate and targeted approach – the controls on larger customers being seen only as a fall-back which is not expected to be a constraint in practice.

Q4 If we adopt such uniform caps, how should the level of gross margin be calibrated and what consequential adjustments should be made (if any) to the remaining default tariff caps that would apply to smaller sites?

A uniform cap should be seen as a first step to de-regulation of retail prices for larger customers. In our view, these customers have bargaining power and we think few (if any) of the largest customers will remain on default terms when the retail market opens. Before AMP6 prices for customers using more than 50 MI per were not subject to formal controls; if retail controls were withdrawn charges for this group would still have greater protection than before (because wholesale prices will remain regulated).

Therefore, the proposed gross margin cap for customers using more than 50 MI per year should be viewed very much as a back-stop. If this protection is unlikely to take effect in practice then it can be set at the highest level consistent with industry proposals.



In our approach above, we have excluded Welsh Water from the maximum. The regulations for companies operating wholly or mainly in Wales are entirely different; they are obliged to apply the 2.5% margin to the element of the customer base that is contestable. Most English companies have concluded that the amount of net margin allocated across the customer base should relate to the value that retailers have at risk (i.e. the level of retail cost); this means higher gross margins for smaller customers.

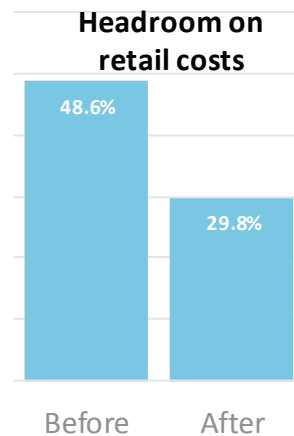
If another band is set to encompass all customers using between 1 and 50 MI/a (or 5 and 50 MI/a as we have proposed), this is a much broader range. However, customers using above 1 MI/a still represent the largest 12% of Severn Trent customers and above 5 MI/a the top 2%. With this group, it also seems likely that a great many will have the time and resource to choose an alternative supplier or negotiate a better deal with their existing retailer. So we think that a uniform cap for these customers should also be seen as a back-stop.

For most companies, a “back-stop” approach would mean uniform gross margins being set at a higher level than they have proposed. In our view, it is unlikely that companies would price up to the higher level just as the market opens; this would appear to be encouraging their customers to defect. In a sense any increase in the “allowed” margin for the large customers is purely theoretical; these customers will not stay on the default rates after the market opens, so incumbents will never earn these additional returns.

We do not think that average revenue controls for smaller customers should be reduced as a consequence of an industry-imposed back-stop. This could impose a margin squeeze on retail for small customers to compensate for higher large user margins which the company has no intention of taking up.

We have looked at the impact that a “zero sum” approach might have. There would be a significant reduction in small customer margins if we were obliged to compensate for higher gross margins in the upper bands. Assuming large customers (using 50 MI/a or more) to 3% and to 6% for customers using more than 10 MI/a, our net margins for our small customers would need to reduce from 3.1% to 2% (based on FD numbers). This would significantly increase the risk that regulated tariffs (which small customers are likely to remain on) could impose a margin squeeze on competing retailers.

The net margin can be thought of as providing companies with a level of headroom above costs. Actual costs will vary from those allowed – particularly since no allowance has been made for the cost of customer acquisition or inflation. Rebalancing – based on the theoretical increase in large user margins - would dramatically cut the headroom available on small customer costs.



The theoretical margin available on large users would, meanwhile, represent a huge return on retail activity – for every pound of retail cost, the retailer would receive around £32 of margin. Some of this is necessary to fund the large working capital requirements for big customers, but it is extremely unlikely that companies would actually earn these amounts – if incumbents do not offer discounts to these customers straight away then competitors would certainly do so.

It is worth noting that – if anything - this analysis **under-states** the increased risk of a margin squeeze.

- Firstly, we have only looked at the impact of rebalancing from customers using more than 10 MI/a to the group using 0-10 MI/a, as we do not currently have a banding at 1 MI/a. The effect of a higher uniform cap for a larger block of revenue would be likely to exacerbate this effect.
- Secondly, retailers have to fund working capital from the allowed net margin. Small customers are typically billed twice per year, making this a significant cost.

We understand that a “back-stop” approach for larger customer could create perverse incentives on companies to load cost and margin onto small users in PR16 submissions. If companies understood that margins for all customers using 1-50 MI/a would be set at 6% regardless of the cost allocated, then a company could maximise revenue by allocating higher cost and margin to the low users where there will be a company-specific allowance.

Therefore, we think that companies should face greater scrutiny where they propose to materially increase the level of revenue recovered from small customers. This is not to say that they should be prevented from allocating costs to small customers if that is appropriate. But where a company’s proposed charges for customers using less than 1 MI/a per year are broadly in line with (or lower than) PR14 levels, these should certainly not be reduced as a result of uniform caps for larger customers.

Q5 If we do not proceed with simplifying the form of control, we welcome views on how we could ensure appropriate allocation of costs and margins and prevent any inappropriate reallocation of costs and margins to individual default tariff caps. In particular, whether we should require compelling evidence that both supports revised allocations and shows that the existing allocations would act as a detriment to competition, before accepting any revised allocations of costs and/or margins?

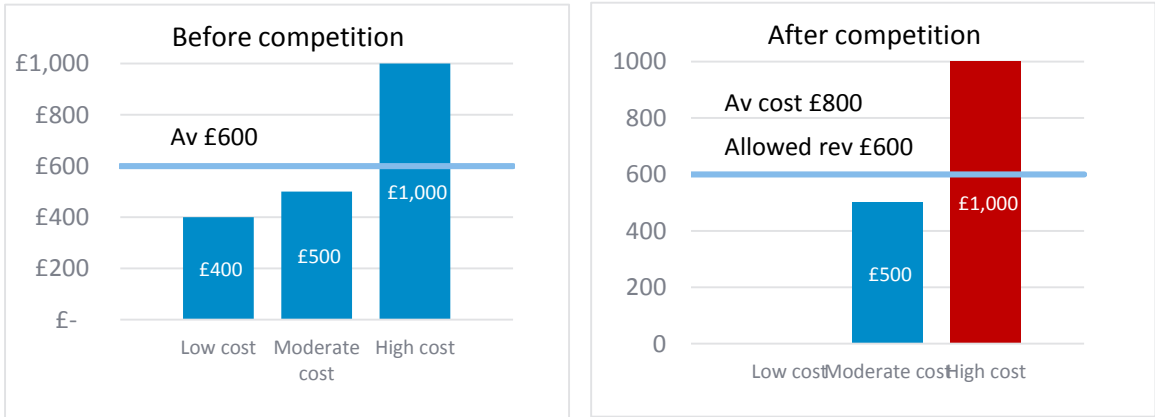
Companies are under a duty to comply with competition law. It is companies' own interest to ensure that they do not impose a margin squeeze through the retail charges they set for any group of customers. In our view, the potential advantage from setting retail controls at an inappropriate level is very small, and the potential penalty from a competition law challenge is very high. Therefore we think that the risk of a company deliberately manipulating average revenue controls to frustrate competition is low.

We will allocate our retail charges in the way that we think is best to ensure compliance with the law – that is, whether an Equally Efficient Operator would be able to serve our customers profitably, based on our assessment of the required retail costs. We will explain which drivers we have used to allocate our costs and would expect there to be dialogue with Ofwat where it considers that there are other, better drivers that might have been used for some aspects of cost. We are happy to provide all of the information that underpins our allocations. However, we would hope that Ofwat does not frustrate companies' attempts to reallocate. We are unable to increase the aggregate level of cost that Ofwat has allowed at PR14 and bear the risks of failing to comply with competition law if a retailer alleges margin squeeze. The form of control also prevents a reduction in wholesale charges from being used to increase margins (since the margin itself, rather than the end user tariff is controlled).

We also think that the industry needs to have sufficient flexibility within controls in order to respond to changes in cost. Therefore, if Ofwat does not introduce the proposed changes to the form of control, then we think that companies should also be allowed to reduce the number of bands in the non-household control. This would enable companies to respond to changes in customer numbers more easily.

Where customers are in a small band (say, a couple of hundred customers), it does not require many customers to switch in order to change the average cost. The defection of attractive, low-cost customers will tend to drive up the average cost to serve for the remainder, thus raising the risk of a margin squeeze.

Example: a band of 100 customers. Of these, 50 are low cost customers, 20 are average and 30 are high cost.



- Before competition, charges for customers within this band can vary between £400 and £1000, and still remain within the average revenue control
- After competition, the low cost customers all move to contracts to save money. The average cost of serving the residual customers is £800, but the control only allows £600, creating a margin squeeze.
- In a broader band – comprising all non-household customers for the service – the removal of 30 large customers would have little effect on the average cost.
- Broader bands would not mean that costs would be displaced onto small customers. On the contrary, it would mean that large, expensive customers could continue to be charged in line with cost of providing their service (as companies are required to do in order to comply with competition law).

Therefore, unless the gross margin control on the largest customers is seen as a back-stop (and therefore set at a relatively high level), we would think that fewer (broader) average revenue controls should apply. We would propose a single average revenue control for each of the services we provide.

Q6 How we should deal with differences between our PR14 final determinations and the present eligibility criteria in respect of categorising HH and NHH customers (that is, which customers will be able to participate in the competitive market)? In particular, whether we should change the definitions of HH and NHH customers in the RAGs (with effect from April 2017) so allowing the automatic adjustment mechanisms within the existing HH and NHH price controls to adjust revenues for these changes in customer numbers?

We think that the change in eligibility is bound to have an impact on allowed revenues for non-household. It is difficult to see how the existing definitions within the RAGs could be preserved. Preserving current RAG definitions would mean treating a site as a household for the purpose of average revenue controls but as a commercial property within the market settlement system (and vice versa). Where properties are deemed to be “eligible”, the charges for such properties would have to follow the non-household scheme in order to allow retailers to compete. There would then be a mismatch when reconciling revenues to controls at the end of AMP6.

If the eligibility criteria *are* changed in the RAGs, then there will be a consequence for household retail revenue. The other side of the equation (the increase or reduction in non-household) should be allowed to occur as a natural consequence of the price control.

In our view, the simplest way to deal with the eligibility changes would be to:

- Set average revenue controls at PR16 based on total allowed PR14 costs and margins, preserving the integrity of the price control settlement. Make no adjustment for prospective changes in eligibility at this point.
- Change the RAGs for 2017/18 to reflect the change in eligibility criteria.
- Companies reflect the switch between controls when setting charges for 2017/18. The average controls mean that the consequences of the switch automatically reduce or increase both the household and non-household controls.

The alternative – that is, having a different definition of non-household in the RAGs – is not practical. From April 2017 some incumbents will exit the retail market. Some of the properties that were classified as households at PR14 will be served by other retailers. Asking other retailers to keep track of households that



have been reclassified in this way so that an adjustment can be made for the purpose of regulatory reporting will be very complex, even if it can be achieved. Whatever is gained by Ofwat in terms of making comparison with PR14 more simple, this would be dwarfed by the complexity of adjusting the real world back to PR14 expectations.

Q7 We welcome views on whether the following approach to the provision of information by incumbent companies as part of this review is appropriate:

We strongly support the view that companies should retain ownership of tariff setting. Companies have a responsibility to comply with competition law, so it is in each company's interests to ensure they have compliant charges. It is entirely reasonable that we should provide evidence to support the changes in our allocations. We will look to demonstrate that retail charges would allow an equally efficient operator to compete.

We briefed our Water Forum about the scope of the PR16 mini-review and intend to provide them with illustrations regarding the incidence effects that would be caused by any changes we make. We will frame our changes in the context of the whole bill as seen by customers (that is, including the wholesale charge which comprises the majority of the bill). We have also undertaken fresh customer research to supplement the work we did on retail competition for PR14.

As we noted in response to Q5, companies bear the risk of a challenge under competition law and must ensure that retail charges do not prevent retail entry. Compliance may require increases for some customers, which will not be popular. In our case, we do not anticipate that PR16 changes will have a material impact in the context of the whole bill – but where reallocation is necessary we do not think that the quality of customer engagement should be a reason for preventing changes that are necessary in order to comply with the law.

Our Board already provides annual assurance that our charges comply with our legal obligations, so we are content to provide a similar statement in respect of our submission for PR16. We will also provide assurance that cost allocations are based on data that has been robustly prepared.