



**Draft statement of method and data table
requirements for the review of
non-household retail price controls.
An Ofwat consultation**

1. Introduction

- 1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing the interests of customers of regulated water and sewerage companies in England and Wales. CCWater has four regional committees in England and a committee for Wales.
- 1.2 We welcome the opportunity to comment on Ofwat's draft statement of its methodology and data requirements for the 2016 review of non-household retail price controls, prior to the non-household retail market opening for water and wastewater in April 2017.

2. General Comments

- 2.1 CCWater supports Ofwat's intention to review the non-household (NHH) price controls set at the 2014 price review (PR14). This will help ensure that the allocation of assumed NHH retail costs and the allocation of the 2.5% net margin is applied correctly by incumbent companies and is reflected in the default tariffs they offer to customers.
- 2.2 Based on analysis by Ofwat and Ernst & Young, we agree that there are insufficient grounds to review the forecast efficient retail costs and the net margin applied at PR14, so the review is focused on how the assumed costs and the net margin have been applied.
- 2.3 While we welcome Ofwat's intention to simplify default tariffs - thus allowing customers to more easily compare the tariffs - we urge caution as this could lead to changes in existing default tariffs that could create winners and losers, with some customers seeing a bill increase. Depending on the scale and impact of the changes, this could damage customer trust in the new market and in the water industry.
- 2.4 If incumbent companies find that their default tariff structures need to change as a result of this review, we wish to see companies engage with their NHH customers on the potential changes, to gather evidence of the level of customer acceptability of these changes. This may also include evidence of customers' views on the period of time over which such changes could be gradually implemented. The suite of information incumbent companies submit for this review should include evidence of customers' views of the default tariff changes (if applicable) as well as evidence to show that assumed costs and the net margin have been applied appropriately. Company board assurance to accompany this information would also give an added incentive to ensure this data is accurate and credible.

3. Responses to the consultation questions

Q1: We welcome your view 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 welcome Ofwat's review of the cost allowances set at PR14 within the NHH retail price controls. We agree that adjustments to the overall level of NHH retail costs allowed for in the PR14 price controls are not required because:

- Ofwat's analysis shows that only four of the incumbent companies saw an increase in their retail costs to serve NHH customers since April 2015 and this was due to company-specific factors that were not outside the control of company management; and
- there remains scope for incumbent companies to achieve greater efficiencies. Four companies have already seen actual NHH retail costs in 2015-16 slightly below the Ofwat PR14 assumption.

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

We welcome Ofwat's review of the net margin, in terms of its relation to retailers' working capital and credit requirements, and how it may (or may not) encourage competition from new entrants.

We agree with Ofwat's conclusion that a 2.5% margin is sufficient because:

- The Competition and Markets Authority's investigation of the energy sector appears to support a net margin of 1% to 3%; and
- Ofwat's analysis of recent developments in working capital and credit arrangements is consistent with the 2.5% net margin.

We would be concerned if Ofwat were to increase the margin at customers' expense. This could damage customers' trust and confidence in the new market.

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.

The existing complexity and variations in default tariffs may be difficult for customers to engage with - particularly if a customer wishes to make tariff comparisons when considering whether to switch retailer.

Because of this, we agree with Ofwat's suggestion to simplify the form of the NHH retail price control by introducing caps on the gross margins for customers with higher consumption of water. This could be simplified to two bands covering consumption of 1 to 50 megalitres per annum, and 50 megalitres plus, as Ofwat suggests in the consultation paper.

However, while this may improve clarity and comparability, we urge caution as such simplification may lead to some change in the default tariffs currently offered to NHH customers.

Some customers could see a bill increase as a result, so it is important that incumbent companies engage with their customers on any such changes. Companies should gather evidence of the level of customer acceptability of these changes. This may also include evidence of customers' views on the period of time over which such changes could be gradually implemented.

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?

Incumbent companies are better placed to suggest how the gross margin of uniform caps could be calibrated. The two band structure Ofwat suggests may be an effective option.

We note that Ofwat seeks to ensure that such calibration in the setting of gross margins for these caps is implemented in a way that mitigates any impact on customers. This could be achieved if the uniform cap is consistent with the underlying NHH default tariff structure that exists within it. We agree that this should be an objective in the process of calibrating the margin. However, if existing tariffs are inconsistent with a new uniform cap, and cannot be calibrated, companies should gather evidence of customers' views on the changes to the default tariffs (and whether such changes should be phased on over a period of time), as stated in our response to question 1 above.

For smaller sites using less than 1 megalitre of water per annum, adjustments would be justified if the existing tariff caps for these customers are inconsistent with any changes to the NHH retail price control based on a bespoke cap on gross margins for this customer group.

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 to 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?

If Ofwat decides against simplifying default tariffs, it is important that incumbent companies' allocation of costs and margins within the price control are appropriate so as not to give themselves an unfair competitive advantage, increase their margins, or offer NHH customers tariffs that are higher than the cost to serve.

As incumbent companies have an obligation to comply with competition law, this should act as an incentive to apply costs and margins appropriately. However, we agree with Ofwat's suggestion that as an extra safeguard, Ofwat should assess the information companies provide as part of this review to show how allowed costs and the net margin complies with their default tariffs. If there is evidence that the tariffs are inconsistent, Ofwat should intervene if such tariffs are detrimental to the market or to customers.

Q6: How should we deal with differences between our PR14 final determinations and the present eligibility criteria in respect of categorising HH and NHH customers (this 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 Regulatory Accounting Guidelines (with effect from April 2017) so allowing the automatic adjustment mechanisms with the existing HH and NHH price controls to adjust revenues for these changes in customer numbers?

We recognise that refining the market eligibility guidelines may mean for some companies the customer numbers assumed in their PR14 NHH price control may require adjustment. Of the options Ofwat set out for this, we agree that a change to the eligibility definitions in the Regulatory Accounting Guides is appropriate, so adjustments can be applied where needed in the caps set in 2016. We note that the majority of companies have stated to Ofwat that there is only a modest difference in the number of customers when the eligibility definitions were refined.

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

While incumbent companies are better placed to comment on both the proposed process for submitting information, and scope of information required to enable Ofwat to carry out its assessment, we do have some comments on Ofwat's overall approach. We agree that:

- incumbent companies should retain ownership of tariff setting and compliance with competition law;
- incumbent companies should publish their supporting evidence to show how their default tariffs are consistent with the price control that has been set; and
- such information should have company Board assurance, just as business plans submitted at PR14 required this.

Most importantly, we would like to see any changes to default tariffs resulting from this review subject to incumbent companies' engaging with their customers to measure their acceptability of the changes and whether they should be gradually phased in. Any proposed changes to tariffs should be supported by evidence that customers accept this, as well as evidence that competition law and Ofwat's allowed costs and net margin have been complied with.

4. Enquiries

Please send questions about this consultation to:

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