

# **Southern Water**

## **Consultation on the restructuring of wholesale charges to retailers in the English business customer retail market**

25 November 2016

## Contents

---

Introductions .....	3
Background to the proposal.....	4
The proposed changes to Southern Waters wholesale.....	4
Compliance with Ofwat's wholesale charging rules.....	6
Timing.....	6
Responding to this consultation.....	6

# Introduction

## **Southern Water consultation on the restructuring of wholesale charges to retailers in the English business customer retail market**

On 24 June 2016 Southern Water announced that it will sell its existing non-household retail business to Business Stream when the competitive market opens in April 2017. Southern Water will continue to serve non-household customers until April 2017 when Business Stream will take over these accounts on day 1 of market opening (“Day 1”). Southern Water will continue to look after the pipes and infrastructure for all its customers across Kent, Sussex, Hampshire and the Isle of Wight – known as wholesale services.

Charges for these wholesale services are set each year. Wholesale charges will be paid by all retailers who wish to serve water and wastewater customers in our region. As part of the orderly transfer of non-household customers from Southern Water to Business Stream on Day 1, Business Stream has asked Southern Water to consider making a change to the way in which it sets its wholesale charges, to ensure that while the market adjusts to the new competitive environment, Southern Water’s non-Household customers transferring to Business Stream are not significantly affected by such transfer. Business Stream’s concern is that the current tariff structure is not reflective of the costs that will be incurred by retailers in the competitive market. Business Stream has therefore asked us to consider an amendment to the wholesale charging structure which in their view would ensure that customers’ bills are not subject to significant changes overall<sup>1</sup>.

The change would involve adding a new fixed element to our wholesale charges and an appropriate reduction to the volumetric element, in order to ensure that the wholesale tariff contains both a fixed and a variable element. This structure is similar to the structure of wholesale tariffs of other water and wastewater companies and it would not result in Southern Water collecting any additional revenues. Similarly, this would not involve any cross-subsidy between Southern Water and Business Stream. The purpose of the amendment is to prevent incidence effects for customers who will transfer on Day 1.

The indicative charges published by Southern Water on 30 September 2016 do not reflect these proposed changes.

Southern Water is committed to the creation of a level playing field and contributing to the success of a competitive non-household market. Accordingly, before making any decision on the proposed change to its wholesale tariffs, it would like to seek the views of all potentially affected retailers and interested parties; in particular on (i) whether such a change to Southern Water’s wholesale charges should occur, (ii) if so, the level at which the fixed element should be set or the methodology to arrive at that level, and (iii) whether this change should be phased out over time or kept under review.

This document explains the background to the proposal put to us by Business Stream and the potential impact on our wholesale charges for a range of customer types. Details of how to respond are provided at the end of the document.

---

<sup>1</sup> Customers’ charges may be affected by other factors, such as increases in the regulated level of the wholesale charges but would be neutral to the proposed amendment to the wholesale charging structure.

## Background to the proposal

Currently, Southern Water's retail margins<sup>2</sup> (the difference between the final tariff paid by customers and the wholesale tariff) for supply to business customers take the form of a fixed annual charge, based on a banded structure. The tariff bands are based on the volume of water supplied and/or the volume of sewage returned to the sewerage system. Within a given tariff band, all customers pay the same level of retail charge, regardless of their volume. Table 1 below sets out Southern Water's 2016-17 retail margins for business customers.

Table 1. Southern Water business retail margins 2016-17

Tariff band	Water Supply £/a	Sewerage £/a
Unmetered	18.20	25.85
0 to 1 MI/a	33.89	32.85
1 to 5 MI/a	160.09	197.66
5 to 20 MI/a	466.40	597.86
20 to 100 MI/a	760.49	1,239.95
100+ MI/a	3,335.33	3,551.91

Business Stream has told us that it is concerned that these fixed charges do not accurately reflect the costs that will be incurred by retailers in the competitive market from 2017, some of which vary with volume, such as working capital and bad debt. Accordingly, Business Stream have suggested that part of these costs should be included in a variable element of the retail margin.

## The proposed changes to Southern Water's wholesale charges

The proposed changes would amend the wholesale charging structure, by introducing a fixed element and reducing the variable element by an equivalent amount. This would mean that the retail margin could be split between a fixed and variable element without making any changes to customers' overall charges. This is illustrated in table 2 below for the water supply 0-1MI tariff band (2016/17 tariffs).

---

<sup>2</sup> "Retail margins", as set out in Ofwat's PR16 draft determination (September 2016), include the retail net margin (set at 2.5% for companies operating wholly or mainly in England) and an allowance for non-household retail costs. The retail element of the final tariff is subject to an average revenue control set by Ofwat to protect customers for a period of three years.

Table 2 – Illustrative Change to Charges, 0-1MI Tariff Band <sup>3</sup>

Existing		Proposed		
	Standing charge £	Volume charges £ per m3	Standing charge £	Volume charges £ per m3
<b>Wholesale charge</b>	0.00	1.251	16.95	1.170
<b>Retail margin</b>	33.89	0.000	16.94	0.081
<b>Customer tariff</b>	<b>33.89</b>	<b>1.251</b>	<b>33.89</b>	<b>1.251</b>

As shown in Table 3 below, depending on their annual volume, the proportions of wholesale charges and retail margin making up the total charges will change, but the overall charge to the customer will remain the same. The total wholesale revenue recovered by Southern Water will also remain the same.

The proposed changes to the wholesale charges would be published and applied to all retailers in the Southern Water area.

Table 3 - Bill illustrations for water supply charges

Charge	Wholesale variable charge £	Wholesale fixed charge £	Total wholesale charge £	Variable retail margin £	Fixed retail margin £	Total retail margin £	Total charge £
<b>50 m3/a</b>							
<b>Current</b>	63	n/a	63	n/a	34	34	97
<b>Proposed</b>	58	17	75	5	17	22	97
<b>Difference</b>	(5)	17	12	5	(17)	(12)	0
<b>100 m3/a</b>							
<b>Current</b>	125	n/a	125	n/a	34	34	159
<b>Proposed</b>	116	17	133	9	17	26	159
<b>Difference</b>	(9)	17	8	9	(17)	(8)	0
<b>180 m3/a</b>							
<b>Current</b>	225	n/a	225	n/a	34	34	259
<b>Proposed</b>	209	17	225	17	17	34	259
<b>Difference</b>	(17)	17	0	17	(17)	0	0
<b>500 m3/a</b>							
<b>Current</b>	626	n/a	626	n/a	34	34	659
<b>Proposed</b>	579	17	596	46	17	63	659
<b>Difference</b>	(47)	17	(29)	46	(17)	29	0
<b>900 m3/a</b>							
<b>Current</b>	1,126	n/a	1,126	n/a	34	34	1,160
<b>Proposed</b>	1,043	17	1,060	83	17	100	1,160
<b>Difference</b>	(83)	17	(66)	83	(17)	66	0

Note: All figures have been rounded to the nearest whole number. Some numbers may not add up due to rounding

<sup>3</sup> The majority (80-90%) of Southern Water's non-household customers fall within this band.

## Compliance with Ofwat's wholesale charging rules

Ofwat's wholesale charging rules reflect a number of key charging principles, including the cost-reflectivity of charges and the predictability and stability of customer bills. It is widely acknowledged that there can be tension between these two principles and in these circumstances trade-offs have to be considered.

The proposed changes to wholesale charges would not be reflective of a specific cost category - though it is arguable that, at least in the short term, many wholesale costs are fixed. But, Business Stream have indicated that the changes would result in more stable bills for customers transferring from Southern Water to Business Stream.

This consultation is about the structure of Southern Water's wholesale charges. The proposal does not create a cross-subsidy between wholesale and retail charges. Overall this proposal is revenue-neutral for Southern Water.

## Timing

We consider that, given the likely evolution of the retail market following the introduction of competition in April 2017, this change to Southern Water's wholesale charges should be a temporary measure, and should be reassessed in due course, to ensure that customers transferring to Business Stream as a result of Southern Water's exit are not adversely affected. Again it is a question of balancing the principles of cost-reflectivity with price stability and certainty for customers. We are mindful that the change is not driven by a specific cost, and if the fixed element of the wholesale charge was reduced over time any potential price increases in the final tariffs for customers could be smoothed over a number of years. On the other hand, a permanent amendment may, according to Business Stream, avoid altogether any incidence effects for customers.

## Responding to this consultation

The changes proposed by Business Stream would affect all retailers. Therefore, before making a decision on the proposal from Business Stream, we are seeking views of all affected retailers and other interested parties on the change.

We would welcome views on any aspect of the proposals but in particular:

1. Do you support the introduction of a fixed element to Southern Water's wholesale charges, as set out in this consultation, in order to provide business customers with more stable bills on Day 1?
2. If a new fixed wholesale charge were introduced by Southern Water, do you agree that this should be phased-out over a period of time?
3. If you agree that the new fixed charge should be a temporary change, over what period do you think it should be phased out?
4. Do you have a view on the level at which such a fixed wholesale charge should be set or a methodology to set such a charge?
5. Do you have any other views that you would like to express in connection with this consultation?

We would like to hear your views by no later than Friday 9 December. Please provide your response to:

E-mail: [Regcorrespondence@southernwater.co.uk](mailto:Regcorrespondence@southernwater.co.uk)

Post: Wholesale Charges Consultation  
FAO: Dylan Freeman  
Southern House  
Yeoman Road  
Worthing  
West Sussex BN13 3NX

If you would like to discuss, or receive further information on any aspect of this consultation please contact our Market Reform Manager, Dylan Freeman, by email at [dylan.freeman@southernwater.co.uk](mailto:dylan.freeman@southernwater.co.uk).

