



Southern Water

Restructuring of wholesale charges to retailers in the English business customer retail market

January 2017

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About this document

This document sets out our decisions in respect of the restructuring of Southern Water's wholesale charges to retailers in the non-household retail market. It also summarises the responses we received to our consultation and responds to the issues and evidence raised by stakeholders, which we have taken into account in setting our wholesale charges.

Background

In November 2016, Southern Water consulted on proposed changes to the non-household wholesale charges which will be applicable to retailers for wholesale services from 1 April 2017. The proposal would result in a potential change to the indicative charges, published on 30 September 2016.

In 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. As part of the orderly transfer of non-household customers from Southern Water, 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 overall¹.

Currently, Southern Water's retail margins (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.

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 would amend the wholesale charging structure, by introducing a new fixed element to our wholesale charges and an appropriate reduction to the volumetric 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 at market opening.

¹ 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.

Summary of responses and key issues

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, Southern Water consulted with stakeholders to seek the views of all potentially affected retailers and interested parties.

In particular, Southern Water wished to understand stakeholders views on:

- (i) whether such a change to Southern Water's wholesale charges should occur; and
- (ii) if so, the level at which the fixed element should be set or the methodology to arrive at that level;
- (iii) whether this change should be temporary and phased out over time, or kept under review.

Southern Water received six responses to the consultation. Below we set out a summary of the responses to the two key issues:

1. Proposal to modify the wholesale charges to include both a fixed and variable element

All of the retailers that responded to the consultation were either broadly supportive or fully supportive of the proposal to modify the wholesale charges. There was a general consensus that the wholesale charges should be amended to contain both a fixed and variable element. The change was supported as it was generally accepted that a proportion of the retail cost to serve is inherently variable, such as costs for working capital and bad debt, and that the previous charging structure did not appropriately allocate these variable costs across the tariff bands.

One retailer did raise a concern regarding retail incidence effects, stating that there were limitations to the percentage that retail margins could change.

2. The level of the fixed element of the charge

We received differing views on the level of the fixed charge. One retailer supported the proposal in principle, but had a concern that the fixed charge in the example provided, would be an insufficient retail margin at the low end of the illustrative tariff band. Another retailer stated that their modelling indicated that the variable element of the retail margin should be between 40% and 70%, depending on the tariff band. A further retailer stated that the fixed charge should be such that the retail margin was 50% of the variable charge.

We also received a view from a stakeholder that wholesalers should be mindful of the need to ensure their charges comply with Ofwat's charging rules and are both cost reflective and seek to avoid any significant bill impacts for customers.

3. Timing of the fixed wholesale charge

Several of the retailers believed that the fixed element of the wholesale charges should not be phased out over time. It was argued that consistency of charging structures across wholesalers is important and that phasing out the fixed charge could lead to customer bill impacts.

However, views from regulatory and consumer organisations were very clear, stating the need for wholesale charges to be compliant with Ofwat's charging rules. These allow for temporary adjustments to offset any significant bill impacts but also require charges to be cost reflective. One stakeholder stated that they were concerned that the proposal would not be appropriate or sustainable if the changes resulted in charges becoming less cost reflective with consequences or impacts on customers over time that were unfair.

Evaluation and Decisions

Decision 1

Given the broad support we received from retailers, we intend to introduce a fixed element to the wholesale charge. We believe this is supported by retailers to ensure appropriate charge structures and, as the incumbent water company, we believe that we have a responsibility to ensure that our customers are looked after and that their bills remain stable following our proposed exit from the market.

With regards to the response concerning retail incidence effects, we have an obligation to ensure that our charges are compliant with Ofwat's charging principles on predictability and stability for customers, including for the retail margin.

Decision 2

The level of fixed wholesale charge will be in the range suggested in the responses received from retailers. This will be reflective of the variable retail margin in order to achieve the purpose of the amendment which is to prevent incidence effects for customers who will transfer at market opening.

Decision 3

Whilst several respondents felt that the introduction of the fixed element of the wholesale charge should remain in place permanently, we had strong views expressed from regulatory and consumer organisations that any adjustments for incidence effects should be temporary and that charges need to comply with Ofwat's charging rules in relation to cost reflectivity in the long term. Given that the fixed charge is not driven by a specific cost, it is our intention to phase out the new fixed wholesale charge over time. Therefore, the wholesale charges will be a temporary restructuring to avoid immediate incidence effects and ensure that customers transferring to Business Stream as a result of Southern Water's exit are not adversely affected.

Next Steps

Following this consultation and decision document, we will be publishing our new wholesale charges scheme on 13 January 2017 in line with the decisions in this document.

Appendix 1 - List of Respondents

Anglian Water Business
Clear Business Water
Consumer Council for Water
Three Sixty
Business Stream
Regent Water

Other stakeholders expressed an interest in the consultation but did not submit a response.