Modification of the conditions of appointment of Southern Water Services Ltd as a water and sewerage undertaker

On 25 November 2010 Ofwat began a consultation on a proposal to modify the conditions of appointment of Southern Water Services Ltd as a water and sewerage undertaker. The consultation ended on 4 January 2011. Ofwat received no substantive comments on the proposed modification. On 8 February 2011 we made the proposed modification of condition B of Southern Water’s appointment and it came into effect on 9 February 2011.

This notice gives our reasons for making this modification.

Introduction

Southern Water, in accordance with its 25 year Water Resource Management Plan approved by the Secretary of State, is implementing a programme of universal metering for household and mixed use customers. It will install 486,657 water meters between 2010 and 2015. This means that by 2015, 92% of Southern Water’s household customers will have a meter and pay charges related to the volume of water they use. Where customers cannot have a meter they will transfer to an assessed charge, which will reflect normal consumption for the number of bedrooms in their property.

The move to measured charges means that customers currently paying on an unmeasured basis (i.e. bills based on rateable value) could receive either lower or higher bills in future, with large bill increases for some customers. To make the introduction of metering more manageable for customers, Southern Water has developed a package of transitional support for customers. This will include advice for customers on how to use water efficiently and will give them time to adapt to their new measured bill. Customers will be able to opt for a “changeover tariff” to phase the move from unmeasured to measured charges. Customers who are switched by Southern Water to measured charges but cannot afford their new measured bill will be able to apply for a “support tariff” which will cap their measured bill at the level of their unmeasured bill. Southern Water will also offer equivalent support to customers moving from rateable value charges to assessed charges and to its sewerage customers subject to other water companies’ universal metering programmes.
The need for a licence amendment

The provision of transitional tariffs means that some customers will initially pay a bill which is significantly lower than their full measured bill. The package of transitional tariffs was developed during 2010. This means that the company will collect less revenue from these customers than was expected when we set price limits in 2009 for the period to 2015.

Under the changeover tariff, a customer would move gradually from their current unmeasured bill to their eventual full measured bill. To achieve this, their bill would be based on a gradually reducing proportion of their unmeasured charge and a gradually increasing proportion of their measured charge.

Condition B of Southern Water's Appointment as a water and sewerage undertaker limits the amount it can change its charges each year. Ofwat sets one overall price limit for a "basket" of standard charges. Within that basket, changes in measured charges are calculated in a different way to changes in unmeasured charges. Condition B currently says that measured charges are those where all or part of the charge is based on measured consumption. This means that the changeover tariff will be treated as a measured charge, even though a proportion of the bill will still be based on the customer's unmeasured charges. This would have prevented the company from recovering the revenue it needs to deliver necessary investment and to run its operations.

We therefore looked at ways to ensure that the company is able to provide transitional support for customers as it moves them to measured charges. We concluded that it was reasonable to amend Condition B of Southern Water's Appointment for this purpose.

The licence amendment

Ofwat considered different options for amending condition B of Southern Water's Appointment. We concluded that the optimal approach was one that minimised increases in prices in any one year, while allowing Southern Water to recover its expected revenues. Customer research at the 2009 Price Review showed that 85 percent of Southern Water's customers supported smoother bill changes across the period.

The modification to Condition B accepted by Southern Water applies a transitional adjustment of 1.4% to Southern Water's charges in 2011-12. This will enable Southern Water to recover its expected revenues while still offering the package of transitional tariffs. The impact on customers' bills takes effect in 2011-12, when the company's K factor is 0.0% as set in Ofwat's Final Determination in November 2009.
The licence modification allows Southern Water to ask Ofwat to make a further adjustment in 2014-15, if it is needed, and requires Southern Water to give Ofwat the information needed to determine whether there should be an additional adjustment in 2014-15.

Ofwat has also removed paragraphs from Condition B which are only relevant to previous charging years and are no longer valid.

**Ensuring the company does not recover too much revenue**

The impact on other customers' bills associated with the transitional tariffs is uncertain because it depends on the number of customers who opt or are eligible for the tariffs. However, outline modelling based on a medium impact scenario used to calculate the 1.4% adjustment, showed an average impact of £2 per annum on the water bill and £4 per annum on the sewerage bill for all tariff basket customers in each of the four charging years to 31 March 2015.

Given the uncertainty surrounding the impacts of the transitional tariffs, Ofwat will review the revenue impacts of the transitional tariffs and the revenue recovered by Southern Water at the end of the 2012-13 and 2013-14 charging years.

If at the end of 2013-14, it is found that the transitional adjustment in 2011-12 has not allowed the company to recover the full revenue shortfall resulting from the transitional tariffs, the modification allows Southern Water to ask Ofwat to make a further adjustment for the 2014-15 charging year to ensure that the full revenue shortfall is recovered. In 2015, Ofwat will in any case as part of its review of price limits apply the revenue correction mechanism to ensure that Southern Water does not receive any more revenue overall as a result of this modification to Condition B of its Appointment.

On the other hand, if by the end of 2012-13 take up of the transitional tariffs is forecast to allow Southern Water to recover more revenue as a result of this modification than the revenue reductions associated with the transitional tariffs over the period to 2015, it will in accordance with the undertaking described below give up the appropriate amount of its K factor for 2013-14 and return this revenue to customers. The same process will apply at the end of 2013-14.

Southern Water has provided to us a formal undertaking that it will:

- offer its proposed transitional tariffs for all customers subject to its metering programme, including customers' switched to assessed charges;
• offer equivalent tariffs to its sewerage customers where they are subject to other water companies’ compulsory water metering programmes; and

• give up the appropriate amount of its K factor for 2013-14 and 2014-15, if, by the end of 2012-13 and 2013-14, take up of the transitional tariffs is forecast to allow it to recover more revenue as a result of this modification than the revenue reductions associated with the transitional tariffs over the period to 2015.

Responses received to the consultation

A number of customers responded to our advertisement of the consultation and were provided with a copy of the consultation document, but we did not receive any substantive comments on the proposed modification.

Conclusion

Having assessed the case for a company-specific licence modification and received no substantive comments on the proposed modification, we decided for the reasons set out above to make the proposed modification of condition B of Southern Water’s appointment. This modification became effective on 9 February and we approved the company's Charges Scheme for 2011-12 on 14 February 2011.