Affinity Water

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Ofwat
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Dear Stephen,

RESPONSE TO OUR 29 AUGUST DRAFT DETERMINATION

I welcome the opportunity to respond to your Draft Determination (DD) for our non-household retail default tariffs published on 29 August. I also wanted to make a couple of observations relevant to our determinations for retail household and wholesale that relate to new information Ofwat published on the same day.

As an enhanced company we recognise there is an expectation that we should view our DDs in the round rather than respond on every point and hence we are restricting our comments to only the most significant issues. We have included a summary table of these issues at Appendix A as requested.

Can I take this opportunity to express my thanks to you and the Ofwat team for your continued engagement with us and the open and constructive way in which we have worked together on issues raised by both sides.

I also want to stress that we are very proud that Ofwat has granted our Business Plan enhanced status and we are now totally focused on implementing it so we can deliver its benefits for our customers, communities, and other stakeholders. This includes continuing to place customer and community engagement at the heart of what we do.

Non-household retail default tariffs

We welcome that your DD did not make any significant interventions to our proposals. We strongly support your approach in Information Note 14/14 of allowing companies to make proposals about how we could introduce a degree of flexibility into the default tariff settlement.

We expect that at some point in the future regulatory default tariffs will no longer be required, as non-household retail customers will benefit from having choice in a competitive market. But we accept that it is possible that competition may proceed at a different pace for different types of customers. Where choice is not available there may be a role for continued but proportionate regulation.

We can see that experience from other regulated sectors shows it is likely that company tariffs will need to evolve over time. Market opening helps to drive a sharper focus on efficiency, cost allocation and tariff structures. It will be important, therefore, that any default tariffs strike the appropriate balance in terms of affording regulatory protection whilst not distorting competition.

Against this background we think it is our customers' interests that our default tariffs are fixed for the first two years of the AMP and that we have an opportunity to review the arrangements that should apply for the final three years of the AMP shortly before 1 April 2017.

We would want our proposals for default tariffs that apply beyond 1 April 2017 to be informed by prior consultation with our customers and Customer Scrutiny Group (the evolution of our CCG for AMP6). We recognise our proposals should also be subject to independent review by Ofwat.

We have discussed this with our CSG and the Hertfordshire Chamber of Commerce and both are content with our proposals.

Information published on 29 August relevant to our Draft Determinations for retail household and wholesale

Retail household

The information published on 29 August confirms that:

- We face a significant efficiency adjustment for our 'measured cost to serve increment' despite the fact that our average cost to serve for measured customers is well below the industry average (as is the case for unmeasured customers).
- The outcome of 29 August DDs show that it is possible for a company to have higher ACTS than us for both types of customer and not face an efficiency adjustment.
- The range of company specific increments for measured customers ranges from £2.41 to £12.37.

Such a wide range raises significant questions about whether all companies have put forward like-for-like comparisons for the increment. For example, we have included the costs of reading meters, additional billing (because measured customers get billed more frequently) and the costs of additional billing contacts that more frequent billing will cause.

Whilst we appreciate from the 29 August DDs that we are not the only company in this position, we are the only enhanced company in this position. Our measured increment efficiency adjustment is almost double the financial prize we will receive for our enhanced status. This is against the background of our expectation from earlier in the process that enhanced companies would substantially receive their business plans in the round following the Risk Based Review.

The information published on 29 August confirms our view that the measured increment efficiency adjustment in our DD is neither targeted nor proportionate and should not be applied in the case of an enhanced company with average cost to serve below the industry average.

We are, however, very grateful that you have given us an opportunity to review how we allocate efficiencies between measured and unmeasured customers. As you know, we had rather naively allocated all of these efficiencies to the unmeasured cost to serve. This had the effect of unintentionally compounding the measured cost to service increment. We hope you can take our revised submission into account in preparing our Final Determination (FD).

Affinity Water

Wholesale

We appreciated your early warning of your intention to correct for an error you discovered in the DD in relation to third-party costs. But please note this is a significant reduction in the value we had expected from the DD (c£6m over the AMP).

We welcome Ofwat's policy that one of the benefits of enhanced status is that the 'do no harm' rule will apply to any reduction in the WACC Ofwat might apply from the DD to the FD for non-enhanced companies and the policies you introduced on 29 August for the non-enhanced companies in relation to Performance Commitments/ODIs.

Notwithstanding this, we have considered whether we should change our Performance Commitment on supply interruptions lasting for more than 12 hours, where Ofwat's analysis suggested we were not targeting upper quartile industry performance. We remain of the view that this Performance Commitment is fully consistent with the results of the customer research we undertook to support our Business Plan that showed clearly that this was not a priority area for our customers in terms of wanting service improvement in AMP6. They were keen, however, that there was no deterioration in the current service level. Although we do not intend to change the level of this Performance Commitment from the start of AMP6, we do intend to review the situation during the AMP in light of our progress more generally in meeting our suite of Performance Commitments. We have discussed this with our CSG who plan to monitor our performance in this area more closely during the AMP to assess whether they should push us to set a more challenging target.

Regarding the process, we would like to take up your offer of a hearing in late October/early November. In addition, given the complexities involved, could I request that there is an opportunity before the FD is prepared for our modelling teams to engage on how best to achieve our agreed aim of ensuring our year-by-year totex profile and the consequential impact on tax, reflects the profile in our Business Plan (i.e. the approach you took for the determinations for Northumbrian Water and Welsh Water). This is particularly important in light of IN14/15 where we feel we are unable to respond on the implied menu choice as too much uncertainty remains around the underlying annual revenue profile within our DD. It would be particularly helpful if you could specifically send us a revised version of 'Table A9 Affinity wholesale water allowed revenue', as set out on Page 16 of 'Draft price control determination notice: company-specific appendix - the Affinity Water', April 2014.

Yours sincerely

Richard Bienfait
Chief Executive

Appendix A: Summary of issues

Area	Issue	Reference
Retail household	**ACTS Measured increment efficiency adjustment** The information published on 29 August confirms our view that the measured increment efficiency adjustment in our DD is neither targeted nor proportionate and should not be applied in the case of an enhanced company with average cost to serve below the industry average. We face a significant efficiency adjustment for our 'measured cost to serve increment' despite the fact that our average cost to serve for measured customers is well below the industry average (as is the case for unmeasured customers). At the same time, its possible for a company to have higher ACTS than us for both types of customer and not face an efficiency adjustment. We are the only enhanced company in this position. Our measured increment efficiency adjustment is almost double the financial prize we will receive for our enhanced status. We are grateful that you have given us an opportunity to review how we allocate future unplanned efficiencies between measured and unmeasured customers.	Page 2
Wholesale	**Third-party costs error** Error in relation to third-party costs leads to a significant reduction in the value we had expected from the DD (c£6m over the AMP). We appreciated your early warning of your intention to correct for this error.	Page 3
Wholesale	**Application of 'do not harm' to WACC** We welcome Ofwat's policy that one of the benefits of enhanced status is that the 'do no harm' rule will apply to any reduction in the WACC Ofwat might apply between the DD and FD.	Page 3
Wholesale	**Supply interruption greater than 12 hours PC** Ofwat's analysis suggested we were not targeting upper quartile industry performance on supply interruptions lasting for more than 12 hours. We remain of the view that our PC is fully consistent with the results of the customer research we undertook to support our Business Plan that showed clearly that this was not a priority	Page 3

	area for our customers in terms of wanting service improvement in AMP6. We welcome Ofwat's policy that one of the benefits of enhanced status is that the 'do no harm' rule will apply to our PCs and ODIs. Nevertheless, we intend to review our progress during the AMP. We have discussed this with our CSG who are content with this and we welcome their commitment to monitor our performance closely in this area over the AMP to assess whether they should push us to set a more challenging target.	
Wholesale	**Totex profiling, tax implications and menu choice** We request an opportunity before the FD is prepared to achieve our agreed aim of ensuring our year-by-year totex profile and consequential impact on tax, reflects the profile in our Business Plan. This is particularly important in light of IN14/15 where we feel we are unable to respond on the implied menu choice as too much uncertainty remains around the underlying annual revenue profile within our DD. It would be particularly helpful if you could specifically send us a revised version of 'Table A9 Affinity wholesale water allowed revenue', as set out on Page 16 of 'Draft price control determination notice: company-specific appendix - the Affinity Water', April 2014.	Page 3