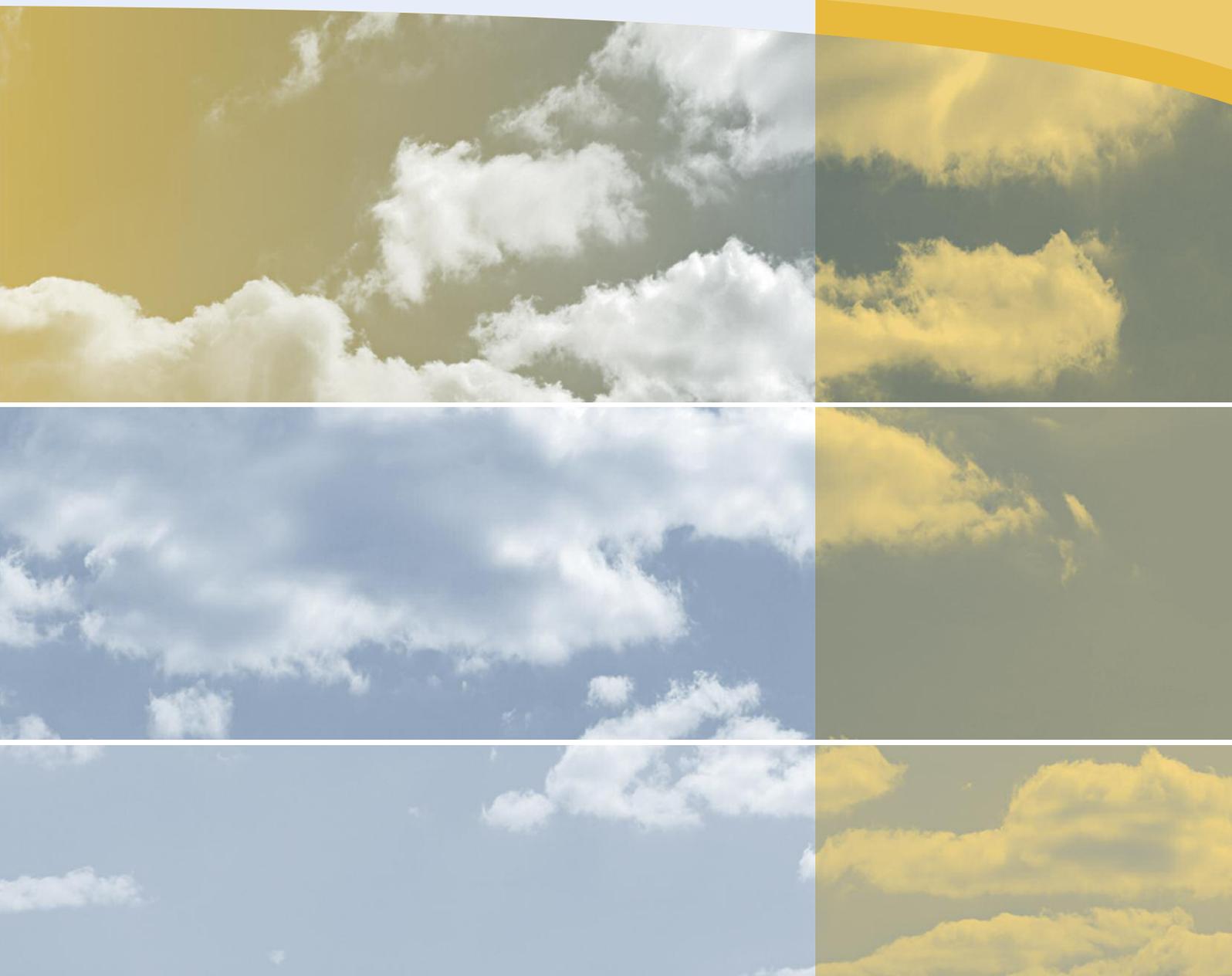


Setting price controls for 2015-20 – final methodology and expectations for companies' business plans

Appendix 2: Setting allowed household retail revenues in practice



A2.1. Introduction

In chapter 6 of our methodology statement we set out our approach to setting allowed household retail revenues. This appendix explains how we will apply this approach in practice.

The process we will follow has the following broad steps, described in turn below.

1. Remove costs of company-specific adjustments from costs assessed in the ACTS.
2. Calculate company costs to serve and the average costs to serve (ACTS).
3. For each company, determine allowed costs to serve (and then allowed unmetered costs) for each year of the price control period.
4. Adjust allowed unmetered costs to account for levels of meter penetration.
5. Add on allowed revenues for company-specific adjustments.
6. Apply the net margin.
7. Adjusting allowed household revenues during 2015-20 for changes in customer numbers and meter penetration from forecast levels.

A2.2. Remove costs of company-specific adjustments

We will first consider and determine whether any company-specific adjustments to allowed revenues will be made. In order to qualify for a company-specific adjustment, the company must demonstrate that a particular factor:

- has a material impact on their costs;
- is beyond efficient management control (having taken all possible steps to control it); and
- impacts the company in a materially different way to other companies.

If we conclude that an adjustment is required, the costs associated with the adjustment will be subtracted from total retail costs **before** the ACTS is calculated.

A2.3. Calculate company costs to serve and the ACTS

The ACTS will be calculated using 2013-14 costs as these will be the latest year of historic costs that will be available when the final determination is set. Companies' costs to serve are then given by dividing their retail costs (excluding costs of serving metered customers and costs associated with any company-specific adjustments) by the effective number of retail customers, incorporating adjustments for economies of scope:

$$\text{Unmetered cost to serve} = \frac{(\text{total retail costs} - \text{metering costs})}{(C_W) + (C_S) + (E \times C_{WS})}$$

Where:

C_W = Number of water-only customers

C_S = Number of sewerage-only customers

C_{WS} = Number of water and sewerage customers

E = Economy of scope adjustment factor

We then calculate the ACTS as a simple, un-weighted average of all companies' unmetered cost to serve.

$$\text{ACTS} = \frac{(\text{sum of all companies' cost to serve})}{(\text{total number of companies})}$$

A2.4. Determine allowed costs to serve and allowed unmetered costs

Our approach to determining allowed costs to serve differs depending on whether a company's unmetered cost to serve is above or below the ACTS:

- for companies with an unmetered cost to serve below the ACTS, we use their unmetered cost to serve to set their allowed cost to serve for every year of the price control period; and
- for companies with an unmetered cost to serve above the ACTS, we set allowed costs to serve using a three-year glide path which reduces from the company's unmetered cost to serve to the ACTS.

Example: determining allowed costs to serve

In this example, the ACTS is £25, Company A has an unmetered cost to serve of £28 and Company B has an unmetered cost to serve of £23. We would then set allowed costs to serve as follows:

	Allowed costs to serve				
	2015-16	2016-17	2017-18	2018-19	2019-20
Company A	£27	£26	£25	£25	£25
Company B	£23	£23	£23	£23	£23

Allowed unmetered costs are determined by multiplying the allowed costs to serve by projected customer numbers (adjusted for economies of scope) for each year:

$$\text{Allowed unmetered costs} = \text{allowed cost to serve} \times [(C_W) + (C_S) + (E \times C_{WS})]$$

Where:

C_W = Projected number of water-only customers

C_S = Projected number of sewerage-only customers

C_{WS} = Projected number of water and sewerage customers

E = Economy of scope adjustment factor

A2.5. Adjustments for levels of metering

As well as their unmetered costs to serve, we will also be asking companies to submit the incremental costs associated with serving each of the three types of metered customers (metered water-only customers, metered sewerage-only customers, and metered water and sewerage customers).

We will use these data to calculate three metering adjustment factors – the average costs associated with serving:

- metered water-only customers (M_W);
- metered sewerage-only customers (M_S); and
- metered water and sewerage customers (M_{WS}).

We will do this in a similar way to our approach for unmetered customers. We will collect information of each of these from companies in their business plans. We will then calculate a simple, un-weighted average. Those below the average will get their actual costs and those above the average will get costs based on a three-year glide path to the average.

We will then calculate metering adjustments for each year of the price control period, based on metering adjustment factors and companies' projected levels of meter penetration.

A2.6. Allow revenue for company-specific adjustments

Next we will add on allowed revenue for any company-specific adjustments that are deemed necessary. Any adjustment will be based on our view of efficient costs. Company-specific adjustments will be expressed on a per customer basis, including differences in adjustments for metered and unmetered customers if appropriate.

A2.7. Applying the net margin

Finally, we will determine allowed household retail revenues for each year of the price control period by applying the net household retail margin:

$$\text{Allowed household retail revenue} = (\text{allowed unmetered costs} + \text{metering adjustment} + \text{company-specific adjustments}) \times (1 + \text{net household retail margin})$$

A2.8. Adjusting allowed household revenues during 2015-20

We explained in chapter 2 of our methodology statement that we want to use a change factor to adjust companies' allowed household retail service revenues to reflect differences between actual and projected customer numbers, as well as actual and projected levels of meter penetration.

Beginning in 2016-17, we will apply adjustments to each year's allowed household retail service revenues to account for such differences in the prior year. We will do this by recalculating the prior year's allowed household retail revenue based on outturn customer numbers and levels of meter penetration.

Adjustment to allowed household retail revenue (current year)	=	Allowed household retail revenue (prior year, outturn data) – Allowed household retail revenue (prior year, final determination)
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As explained in chapter 2 of our methodology statement, we will also use a residual revenue correction mechanism to account for any differences between companies' allowed household retail revenues and actual collected revenues over 2015-20.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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