Note of the retail price control workshop held on 26 September

1. Introduction and purpose

On 26 September, Ofwat held a meeting to clarify issues that had been raised in relation to the methodology for retail price controls. This note accompanies the published presentation materials from that meeting and outlines the key clarifications that were made by Ofwat to companies in response to questions they raised during that meeting. It also addresses some outstanding queries that Ofwat agreed to respond to subsequently. It should be read alongside the published presentation materials from the discussion, which can be found on Ofwat's website.

The workshop covered four areas for clarification.

- Cost allocation issues.
- The average cost to serve: how it will work and what costs are included.
- Non-household retail queries.
- Household related company specific adjustments.

Ofwat also outlined the next steps and some forthcoming publications.

Below, this note discusses each of these areas in turn beginning with the key points of clarification that were provided in the meeting and then any additional queries that Ofwat agreed to respond to subsequently.

Before discussing each of the areas and queries, Ofwat set out that the overarching approach to the 2014 price review (PR14) was to seek to give companies ownership of their plans and to enable them to discuss and test their plans more openly with customers. Companies should therefore apply their plan to the business plan tables when completing them and explain what they have done and the approaches they have taken rather than seeking to follow a more prescriptive approach.

2. Cost allocation issues

Ofwat presented some materials (see slides 5-13 of the accompanying presentation) outlining some key clarifications in response to questions raised by companies. During the discussion the following additional clarifications were provided.

How should companies treat developer services expenditure? (Slide 8)

One attendee asked how developer services costs should be allocated between wholesale and retail services in instances where developer services were currently all capitalised but included some activities which were customer facing (for example, dealing with developers directly) and some which were not (for example, physical connections).

Ofwat noted that performing connections and providing services to developers sits within wholesale while the activity of managing developer queries and providing information to developers sits within retail.

Ofwat clarified that the wholesale element of developer services may be capitalised within wholesale in line with companies' capitalisation policies and applicable accounting standards. But companies should not capitalise the retail element of developer services as there is no asset in retail against which to capitalise these costs. The retail element of developer services should therefore be treated as operating expenditure.

How should companies treat water efficiency expenditure? (Slide 10)

Some attendees queried how they should be reporting water efficiency expenditure in the business planning tables.

Ofwat clarified that water efficiency expenditure for 2013-14 should be reported in the total operating expenditure (Line 1).

Ofwat also clarified that under the average cost to serve methodology there is an allowance for 'average' water efficiency expenditure. If companies expect to incur higher water efficiency expenditure than they had in 2013-14 for the 2015-20 period or expect to see a step-change in their water efficiency expenditure (for example, as part of an outcome that was supported by customers), then they should set out any additional (operating or capital) expenditure separately (in block B of the retail business planning tables) and this funding could be remunerated through outcomes.

How should companies treat general and support expenditure? (Slide 11)

One attendee suggested that they first allocated general and support costs on a direct basis (across each of the nine business units for accounting separation purposes) and only then allocated the remaining non-direct costs on the basis of full-time equivalents (FTEs) between wholesale and retail (for price control/business planning purposes) and between household and non-household retail price controls on the basis of customer numbers. The attendee asked whether this approach was appropriate.

Ofwat has subsequently clarified that for the purpose of preparing business plans, we confirm that basis must be the number of FTE employees engaged in wholesale versus retail activities according to the definitions in the methodology statement, unless the costs are directly attributable either to regulated wholesale or regulated retail services.

For general and support costs, examples of ‘directly attributable’ costs could include the costs of a dedicated finance manager for the retail business or insurance premiums which relate only to the retail business, where no apportionment or proxy is required to attribute the costs between wholesale and retail.

Within retail, an example of ‘directly attributable’ costs would be the costs of a customer services team which only deals with non-household customers, the costs of which could be allocated directly to retail non-household services. Where an apportionment or proxy is required, such as the number of household/non-household contacts, the allocation should be made based on the number of household and non-household customers.

How should retail depreciation be presented in business planning tables? (Slide 12)

Attendees queried the basis on which capital costs or depreciation of retail capital should be provided.

Ofwat clarified that for the purposes of business planning tables and setting the ‘average cost to serve’ (ACTS) depreciation should be provided on a historic cost basis for tangible and intangible (that is, billing system software) assets.

In addition, companies are asked to state in their commentary whether their depreciation would be different if reported on a current cost basis (CCD) as it has been historically. If it would be different, companies should also report their depreciation on a current cost basis in their commentary. Since costs have

previously been accounted for on a CCD basis any historic comparisons made as part of the risk-based review of business plans would need to be made using CCD.

How should shared assets be allocated? (Slide 12)

One attendee queried how shared asset costs should be allocated between wholesale and retail.

Ofwat clarified that, as per the regulatory accounting guidelines (RAGs), shared assets should fall into one business unit and one price control based on the primary use of the asset. Assets can then be re-charged to the other business but the total cost should be split between the two businesses (not double counted).

For **existing** assets up to 31 March 2015, the RAGs allow companies to allocate general and support assets across the business units. However, companies should report **new** general and support assets post 1 April 2015 in the business of principal use and recharge to the other business. Companies should provide commentary with their business plan tables on recharges between wholesale and retail.

Do companies need to re-state previous years' retail costs? (Slides 5-13)

One attendee queried whether companies would be required to re-state their previous years' retail costs under the revised cost allocation and retail definition approach and most recent RAG 4.04 guidance.

Ofwat clarified that companies would have to complete such a re-statement exercise and also noted the forthcoming information notice, which would similarly require a further (very minor) adjustment to the definition of retail services.

How are customer numbers defined? (Slide 13)

Attendees queried what the definition of customer numbers was in the business plan tables.

Ofwat clarified that we are asking for customer numbers in business plan table (R3 block E) defined as the average number of properties connected over the year, excluding void properties.

3. The average cost to serve: how it will work and what costs are included

Ofwat presented some materials (see slides 14-27) outlining some key clarifications in response to questions raised by companies on how the ACTS would work including a worked example. During discussion the following additional clarifications were provided:

How will Ofwat treat negative allowances for new capex? (Slide 17)

In considering the approach taken to new retail capex (or depreciation of that capex) as part of the ACTS calculation, one attendee queried whether Ofwat would include negative modifications for new capex (depreciation) if companies were proposing reductions in their capex from that set out in 13-14 for the period 2015-20. Specifically, would a company proposing less or no new retail capex for 2015-20 see its CTS used for calculating ACTS fall (that is, in the worked example on slide 22), if 'Allowed depreciation not in RCV (£m)' was zero for 2015-20 period then would the 'Total costs' line would be £20 million or £18 million?

Ofwat has subsequently clarified that if a company proposes less capex or no capex in retail during 2015-20, then this will not affect the ACTS calculation – which will be based on the historic 2013-14 figures. A modification for future capex would only be included if companies make a strong case for additional capex during the 2015-20 period beyond that which they incur in 2013-14. In the worked example therefore the 'Total costs' line would be £20 million in the example above.

Reporting a glide path to the ACTS in business plans (Slide 20)

Some attendees queried whether companies' should forecast a glide path in their business plans if they expect to be above the ACTS (even though companies will not know the ACTS until after they have submitted their plans). This way they can make their plan more accurate to what they expect to happen, including when engaging with their customers, rather than assuming that they will be allowed whatever costs they put into the table.

Following the workshop, Ofwat can clarify that companies can assume a glide path in their business plans where they anticipate being subject to one. Any glide path that companies propose will influence the modification for future depreciation.

Avoidance of double recovery of historic capex and indexation (Slide 21)

One attendee queried whether when removing existing depreciation from asset management period 5 (AMP 5) from the retail price control there would be any

impact on wholesale regulatory capital value (RCV). The attendee queried whether because AMP 5 depreciation would be reported on a historic cost basis in retail price controls it would affect wholesale RCV given the different historic reporting of AMP 5 capex on a CCD basis.

Ofwat clarified that companies will continue to see the entire RCV from AMP 5 remunerated in the usual way. Removing existing AMP 5 assets from companies' individual ACTS calculations on a historic cost basis will not in any way affect the remuneration of the existing RCV, which will remain in wholesale in its entirety.

Will ACTS use the 2013-14 forecast data from companies' business plans or the actual audited data reported by companies later in 2013-14? (Worked example: Slides 22-26)

Attendees queried whether Ofwat would seek to set the final ACTS based on companies' submitted business plan data or the audited data for 2013-14 that would emerge later that year.

Ofwat has subsequently clarified that it will use the projected 2013-14 data that companies submit as part of their business plans to set the ACTS and that we will not update our ACTS data once companies' audited 2013-14 accounts become available.

The ACTS calculation is simply an efficiency benchmark and the business plan tables include important considerations to arrive at that calculation, such as whether or not companies should be subject to adjustments for certain factors. We therefore consider that it is important to use the figures that companies submit as part of their business plans.

When we receive the audited accounts for 2013-14, we will consider this data alongside the business plan data and will ask companies to explain differences between the two where they occur in their audited accounts.

The data for 2013-14 should be submitted in 2012-13 prices.

How will ACTS be calculated? (Worked example: Slides 22-26)

Ofwat used a worked example to explain how the ACTS calculation would work for a company with costs above the ACTS. The numerical example is repeated and explained further below.

Table 1: Numerical example – how allowed revenue would be calculated for a company above the ACTS

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Operating expenditure (£m)	18	18	18	18	18	18
Depreciation in RCV (£m)	2	1	0.5	0	0	0
Allowed depreciation not in RCV (£m)	0	2	2.5	3	3	3
Modification for future depreciation (£m)	0.7					
Total costs (£m)	20.7					
Customer numbers (millions)	1					
CTS (£ per customer)	20.7					
ACTS (£ per customer)	19.8					
Efficiency challenge (£ per customer)	0.9	0.225	0.45	0.675	0.9	0.9
Allowed CTS (£ per customer) (before adjustments, incl legacy depreciation)		20.475	20.25	20.025	19.80	19.80
Allowed CTS (£ per customer) after removing legacy depreciation per customer		19.475	19.75	20.025	19.80	19.80
Allowed company specific adjustment (£ per customer)		2	2	2	2	2
Allowed recoverable costs £ per unmeasured customer		21.475	21.75	22.025	21.80	21.80
Total retail metering expenditure – water only customers (£m)	2					

Customer numbers (millions)	10					
CTS (£ per customer)	0.4					
ACTS (£ per customer)	0.5					
Efficiency challenge	0	0	0	0	0	0
Additional allowed recoverable costs per measured water only customer		0.4	0.4	0.4	0.4	0.4
Allowed recoverable costs per unmeasured customer		21.475	21.75	22.025	21.8	21.8
Allowed recoverable costs per measured water only customer		21.875	22.15	22.425	22.2	22.2

Notes

1. In the worked example (slide 22), the company sets out operating expenditure over the period 2013-14 and 2015-20 ('Operating expenditure'), the depreciation of capex that is included in retail from AMP 5 investment ('Depreciation in RCV') and depreciation on new retail capex for AMP 6 ('Allowed depreciation not in RCV').

2. The company's 'Modification for future depreciation' of £0.7m per annum is calculated by taking:

    a. the average 'Allowed depreciation not in RCV' and the operating expenditure across price control period ((£2m + £2.5m + £3m + £3m + £3m + £18m + £18m + £18m + £18m + £18m)/5 years = £20.7m per annum) minus
    b. the 'Depreciation in RCV' already allowed for in 2013-14 and 2013-14 operating expenditure (£2m + £18m).

3. The company's 'Total costs' (retail) of £20.7m are then calculated by taking:

    a. 2013-14 operating expenditure (£18m) plus
    b. 'Depreciation in RCV' (£2m) plus
    c. 'Allowance for future depreciation' (£0.7m).

4. The company's individual 'Cost to serve' (CTS) of £20.70 per customer per annum is then calculated by simply taking its total retail costs (£20.7m per annum) and dividing by 'Customer numbers' of 1 million. These figures are for unmeasured customers and the additional costs of serving metered customers are added in at a subsequent step (see slides 24-26).

5. If the ACTS across other companies was equal to £19.80 per customer per annum (slide 23), then the company would need to find an efficiency saving of £0.90 per customer.

6. However, that efficiency challenge would be applied via a three-year glide path, requiring the company to find £0.225 efficiencies per customer in 2015-16, £0.45 per customer in 2016-17, £0.675 per customer in 2017-18 and then the full £0.90 per customer in 2018-19 and 2019-20.

7. The company's 'Allowed CTS (£ per customer)' would therefore be the company's £20.70 per customer per annum minus the applied efficiency challenge over the glide path period (leading to £20.475 in 2015-16, £20.25 in 2016-17, £20.025 in 2017-18, £19.80 in 2018-19 and £19.80 in 2019-20).

8. The company CTS per customer is then altered to remove legacy depreciation per customer to avoid double recovery by companies on these assets (which will continue to be remunerated in the wholesale RCV). This leads to an allowed CTS per customer of £19.475 in 2015-16, £19.75 in 2016-17, £20.025 in 2017-18, £19.80 in 2018-19 and £19.80 in 2019-20.

9. Finally, in the example shown, the company has successfully sought an adjustment to its retail costs of £2 million per annum (this adjustment would need to have been subject to a separate risk based review test and the three criteria stated in the price review methodology – see slides 33-39). This adjustment is then added to give the company's final revenue allowance.

10. The ACTS per customer (slides 24-25) is calculated first by taking the unmeasured cost per customer and then by adding on to that cost the additional cost of serving measured customers. There are three separate calculations/allowances added to reflect this, including for:

    a. measured water only customers;
    b. measured sewerage only customers; and
    c. measured dual service customers.

11. This calculation is shown on slide 26 and follows the same methodology as for an unmeasured customer on slides 22-23. Through this calculation the additional costs of serving a metered customer over an unmetered one are calculated and these are added to the company's unmeasured allowance per customer.

12. The household retail revenue allowances per company are automatically adjusted to take account of the relative number of each of the four customer types that each company has over the price review period.

13. Finally a net margin is added onto the cost per customer at the end of the calculation (slide 26).

What about companies whose costs are below the ACTS? (Slides 22-26)

One attendee queried what would happen to companies with costs below the ACTS.

Ofwat clarified that if companies' specific CTS is below the ACTS, then they will get their proposed actual costs instead of the ACTS (in the worked example on slides 22-23, if the ACTS was £22 per customer rather than £19.80 per customer, the example company quoted would receive its actual costs over the period – that is, the top three lines of cost on slide 22). We will also still add on company-specific adjustments to a company's specific CTS at the end of the calculation and take off any residual depreciation for assets in the RCV.

To further clarify this case, we include the following example.

Table 2 Numerical example – how allowed revenue would be calculated for a company below the ACTS

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Operating expenditure (£m)	15	15	15	15	16	15
Depreciation in RCV (£m)	2	1	0.5	0	0	0
Allowed depreciation not in RCV (£m)	0	0	0.5	1	1.5	1.5
Modification for future depreciation (£m)	0					
Total costs (£m)	17					
Customer numbers (millions)	1					
CTS (£ per customer)	17					
ACTS (£ per customer)	19.8					
Efficiency challenge (£ per customer)	0	0	0	0	0	0
Allowed CTS (£ per customer) (before adjustments, incl legacy depreciation)		15.00	15.50	16.00	17.50	16.50
Allowed CTS (£ per customer) after removing legacy depreciation per customer		14.00	15.00	16.00	17.50	16.50
Allowed company specific adjustment (£ per customer)		0	0	0	0	0
Allowed recoverable costs £ per unmeasured customer		14.00	15.00	16.00	17.50	16.50

Notes

1. As in the first example, the company sets out operating expenditure over the period 2013-14 and 2015-20 ('Operating expenditure'), the depreciation of capex that is included in retail from AMP 5 investment ('Depreciation in RCV') and depreciation on new retail capex for AMP 6 ('Allowed depreciation not in RCV').

2. The company's 'Modification for future depreciation' is calculated by taking:

    a. the average 'Allowed depreciation not in RCV' and the operating expenditure across price control period ((£0m + £0.5m + £1m + £1.5m + £1.5m + £15m + £15m + £15m + £16m + £15m)/5 years = £16.1m per annum) minus
    b. the 'Depreciation in RCV' already allowed for in 2013-14 and 2013-14 operating expenditure (£2m + £15m) = £17m.
    c. The modification for future depreciation is therefore £0m per annum, as b. is greater than a. above and the modification cannot be less than £0m.

3. The company's 'Total costs' (retail) of £17m are then calculated by taking:

    a. 2013-14 operating expenditure (£15m) plus
    b. 'Depreciation in RCV' (£2m).

4. The company's individual 'Cost to serve' (CTS) of £17.00 per customer per annum is then calculated by simply taking its total retail costs (£17m per annum) and dividing by 'Customer numbers' of 1 million. These figures are for unmeasured customers and the additional costs of serving metered customers would be added in at a subsequent step.

5. If the ACTS across other companies was equal to £19.80 per customer per annum then the company would be below the ACTS, and so would not face an efficiency challenge.

6. Because there is no efficiency challenge, there is no glide path.

7. The company's 'allowed CTS (£ per customer)' would therefore be based on the company's actual forecast costs, as these are lower than the ACTS (leading to £15 in 2015-16, £15.50 in 2016-17, £16.00 in 2017-18, £17.50 in 2018-19 and £16.50 in 2019-20).

8. The company CTS per customer is then altered to remove legacy depreciation per customer to avoid double recovery by companies on these assets (which will continue to be remunerated in the wholesale RCV). This leads to an allowed CTS per customer of £14.00 in 2015-16, £15.00 in 2016-17, £16.00 in 2017-18, £17.50 in 2018-19 and £16.50 in 2019-20.

9. Finally, in the example shown, the company has not sought any adjustments (or alternatively, has sought adjustments but not been granted any). There is therefore no adjustment to the allowed revenue and so the company's final revenue allowance is as in 8 above.

10. As there is no difference between how metering adjustments or net margins are treated for companies above and below the ACTS, this is excluded from this example (steps 10-13 in the previous example).

How will Ofwat ensure that the companies' 2013-14 figures are robust and correct? (Slides 14-27)

Some attendees queried how Ofwat would check that the companies' cost figures for 2013-14 were robust and correct.

Ofwat confirmed that it will be reviewing costs as part of its risk-based review exercise and checking for consistency with historic experience and the RAGs.

Why has Ofwat asked for data from 2020-30 in the business plan tables?

One attendee queried why Ofwat had requested information for the period 2020-30 in the business plan tables.

Ofwat clarified that this was to allow companies to take a long-term approach to business planning and to reflect any outcomes or affordability concerns that spanned multiple asset management periods.

How should companies present their proposed retail margins? (Slides 26 and 28)

Attendees queried how companies should present their proposed retail margins and what these margins represented.

Ofwat has subsequently clarified that as per the business planning guidance, the margins proposed by companies should be based on their 'Retail revenues', which would be the same as total revenues – that is, they would include revenues associated with wholesale activities + revenues associated with retail activities. Companies should also set these out as 'margins' rather than a 'mark ups', that is:

$$\text{Allowed household retail revenue}$$

$$= \frac{\left(\begin{array}{c}\text{allowed unmetered costs + metering adjustment + company specific adjustments} \\ \text{+ allowed wholesale revenue for household customers}\end{array}\right)}{(\text{1-household retail net margin})}$$

$$- \text{allowed wholesale revenue for household customers}$$

We note that this is an amendment to the description in the methodology statement.

4. Non-household retail queries

Ofwat presented some materials (see slides 28-32) outlining some key clarifications in response to questions raised by companies on the non-household retail price control. During discussion the following additional clarifications were provided.

How should companies present their proposed non-household retail margins across different customer bands? (Slides 30-31)

Attendees queried what the margin, submitted in the R5 business plan tables, should cover and how this should be allocated.

Ofwat can subsequently clarify that margins should cover the same things as household margins (that is, retail revenues or total revenues) and be set in the same way (that is, a margin not a mark-up). They should also be allocated across different customer bands in the most effective way to reflect costs and risks of serving different customer groups.

The policy objectives of the information provided through table R5 are to:

- provide further details on how companies' proposed retail margins are derived;
- check that they are sufficient to finance the retail business; and
- to ensure that the gross retail margin for different customer bands is sufficient to allow all customer groups to participate in the non-household retail market – that is, that the proposed default tariffs do not represent a margin squeeze.

Companies will need to confirm for themselves that their proposed default tariffs and margin allocation is complaint with competition law.

How should companies deal with input price pressures (on both the household and non-household retail price controls)? (Slides 29 and 33-39)

Attendees queried how they should present any information on input price pressures in their business planning tables and commentary that they may consider they are subject to.

Ofwat clarified that it had set out in the methodology that retail price controls would not automatically be indexed to RPI. Therefore, any request for input price pressure would be treated as an adjustment and subject to the criteria outlined in the methodology (although as Ofwat clarified the first two criteria are likely to be to relevant for input price pressures and the last is unlikely to be). Instead, Ofwat requested that:

- input price pressures on the household side should be included in lines 13 and 14 of table R3 and excluded from line 1; and
- input price pressures on the non-household side should be reflected in the proposed retail margins that companies include.

In both cases, companies should describe the approach that they have taken in their commentary and business plans and clearly set out the evidence that they have to justify any claims for input price pressures.

5. Household related company specific adjustments.

Ofwat presented some materials (see slides 33-39) outlining some key clarifications in response to questions raised by companies on potential claims for adjustments to the household retail price control and the ACTS. During discussion the following additional clarifications were provided.

When are adjustments taken into account in the ACTS calculation? (Slide 39)

Some attendees queried at what point adjustments would be made to companies' retail price controls.

Ofwat clarified that any agreed adjustments would not be included in the ACTS calculation, they would be added in at the end of the process. This is important because if companies do successfully make claims for adjustments then the ACTS level will change and companies may place differently to where they have in previous examples.

6. Next steps

Finally, we described a range of forthcoming consultations and information notices (slide 40).

How can we deal with queries that we have following the retail workshop?

One attendee queried whether there would be a further opportunity to ask questions for clarification after the workshop.

As we set out in information notice 13/07 (IN13/07, '2014 price review communications between Ofwat and water companies') we have now entered the second phase of our communications with companies. This phase is one of restricted communications. However, companies are still able to submit queries to their Portfolio Lead as we recognise unforeseen issues can arise (for example, queries following on from the workshop). As we said in the information notice, where appropriate, we will respond to queries more formally and will issue the response to all companies, using our rolling Q and A which we publish on our website.

Ofwat
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