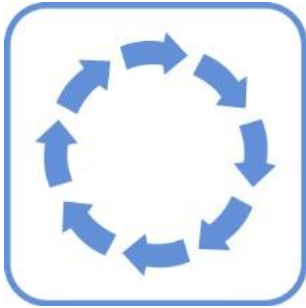




Retail price control workshop

26 September 2013

# Outline of session



- 10.30 Introduction and purpose
- 10.40 Cost allocation issues
- 11.10 ACTS: how it will work and what costs are included
- 12.30 Non-household retail queries
- 1.00 Household related company specific adjustments
- 1.30 Close

# Objective of workshop



To address queries regarding the methodology for retail price controls

**We will specifically cover:**

Cost allocation queries

Average cost to serve method and queries

Non-hh queries

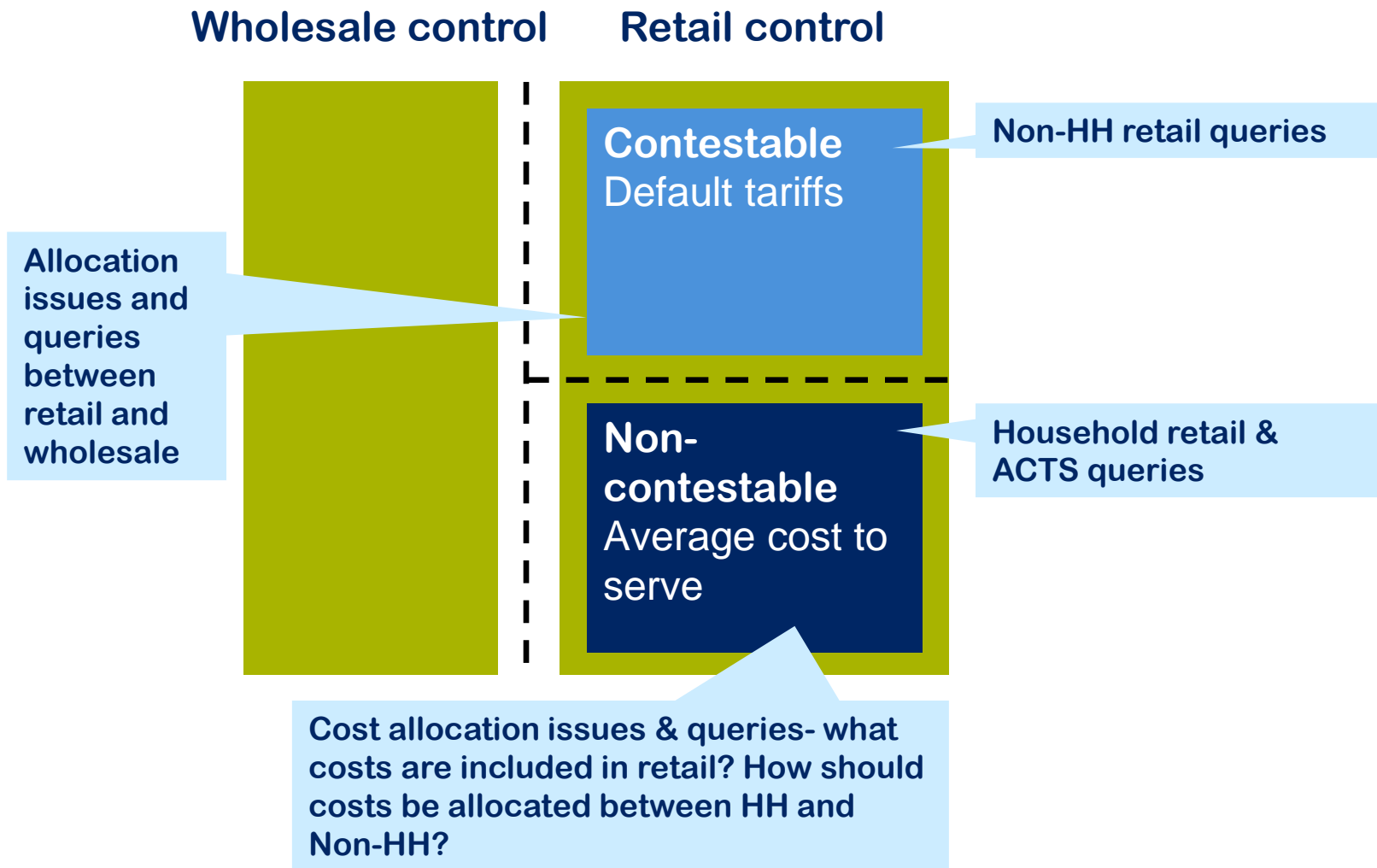
Company specific adjustments

**Alongside workshop materials we will publish:**

The delegate pack and slides

A note of the meeting, including any relevant Q&A

# What queries have companies raised?





## 1. Cost allocation issues

# Methodology queries (1) – Retail definition

## Confirmed retail definition [Subject to forthcoming information notice]

To be applied to future and prior years' costs in the business plan

<b>Activities and services included in retail</b>	Customer services including: <ul style="list-style-type: none"><li>• billing</li><li>• payment handling</li><li>• remittance and cash handling</li><li>• vulnerable customer schemes</li><li>• network and non-network customer enquiries and complaints</li></ul> Debt management and doubtful debts Meter reading Other operating costs including: <ul style="list-style-type: none"><li>• decision and administration of disconnections and reconnections</li><li>• demand-side water efficiency initiatives</li><li>• customer-side leaks</li><li>• other direct costs</li><li>• general and support expenditure</li><li>• scientific services</li><li>• other business activities</li></ul> Developer services <ul style="list-style-type: none"><li>• providing developer information</li><li>• administration for new connections</li></ul> Local Authority rates
<b>Activities and services not included in retail and instead included in wholesale</b>	Meter ownership Trade effluent compliance monitoring Disconnections and reconnections (physical activity) Meter installation, maintenance and replacement – but a role for retailers in determining meter functionality and capability

## Consistency between business plan guidance and RAG 4.04

Confirmed retail definition matches the allocation of activities in RAG 4.04 from 2012-13

Business planning tables ask for information to account for retail activities funded by wholesale (for example customer-side leaks and demand-side water efficiency) to provide assurance that these are not double counted

### **Business planning guidance provides clarification of treatment of particular costs at a more granular level than RAG 4.04, including:**

Customer services – network calls

Scientific services – sampling at customer tap [Subject to forthcoming information notice]

Regulation costs – allocate 1/9 to retail

General and support costs – allocate based on FTEs

Household and non-household – allocate based on customer numbers

Definition of household – as per previous June return guidance

## **Developer services**

Confirmed definition (as in the methodology and RAG 4.04)

### **Retail activities**

Providing developer information

Administration for new connections

### **Wholesale activities**

Provision of connection for developers

Same approach as in Scotland



## Network calls

### Business planning guidance

“The costs of network enquiries and complaints within retail operating costs should include the costs of:

- scheduling jobs where they are triggered by a customer call
- visiting the customer to investigate the problem
- internally generated calls to the retail call centre to enable the customer call to be resolved”

### Additional clarification: Investigatory visits

Scenario: Wholesaler may visit the customer at the request of the retailer (following a customer contact) to investigate the problem. Wholesaler would look to recover costs from the retailer if no network issue is found

The costs of initial investigation should be in retail, where this is driven by a customer call and is found not to be as a result of a network issue

## Water efficiency expenditure

### Additional clarification

Water efficiency expenditure related to a compulsory metering programme is a wholesale cost

Business as usual water efficiency expenditure is a retail cost

Compulsory metering costs from the point of charge (reading, billing, contacts) are retail costs

## Cost allocation basis

### Business planning guidance

General and Support expenditure should be allocated between wholesale and retail on the basis of full-time equivalents (where not directly attributable to retail or wholesale)

Retail costs should be allocated between household and non-household on the basis of the number of household and non-household customers (where not directly attributable to household or non-household)

### Additional clarification

This applies to prior years' retail costs as well as future years' retail costs

## Depreciation

### Business planning guidance

“The depreciation charge on tangible fixed assets related to household customer retail... Depreciation should be reported on the same accounting basis as will be used for 2015-16, that is historical cost IFRS, FRS101 or FRS102. Note that this figure is not net of the amortisation of deferred credits and intangible assets”

### Guidance change

Depreciation should be provided on a historic cost basis for tangible and intangible (that is billing system software) assets as in the table guidance

In addition, please state in your commentary whether your depreciation would be different if reported on a current cost basis (CCD). If it would, also report your depreciation on a current cost basis in your commentary.

CCD for AMP5 should be consistent with the regulatory accounts

## Customer numbers

### Business planning guidance

Definition is as per our October 2012 information request on same

For each class of customer, customer numbers is:

Properties billed = properties connected less voids

Numbers should be reported as average number of households billed for each type within the supply area for the year



2. Average cost to serve:  
How it will work and what costs are included

# Overview of ACTS

Confirmed in methodology that household retail controls will use Average Cost To Serve (ACTS)

**Approach calculates a separate ACTS for:**

Unmetered customers and the additional cost of serving  
Water only metered,  
Sewerage only metered  
Dual service metered customers

Adjustments will not be included in ACTS calculation. We will add these back on to company CTS after applying the efficiency challenge

Hand-out in delegate pack details ACTS calculation

# Calculating companies CTS

Each companies unmeasured Cost To Serve (CTS) is calculated using:

$$\text{Unmeasured CTS} = \frac{\text{Total costs (opex and depreciation)– metering costs}}{\text{Total number of customers}}$$

**This is based on figures from business plan table R3 & includes:**

Total operating expenditure in 2013-14 (Line 1)

Total depreciation of assets included in RCV 2013-14 (Line 2)

An adjustment based on total depreciation of assets that are not included in RCV (Line 3)



# Any future capex in retail

If companies consider that 2013-14 depreciation in ACTS does not provide sufficient capex allowance for AMP6, then they can propose new depreciation which we will challenge through RBR expenditure test

Assets shared with wholesale should be accounted for in wholesale and charged back to retail

## Calculated using:

(Average depreciation **not** included in RCV across price control period  
+ average forecast operating expenditure across price control period)  
– (depreciation of assets included in RCV in 2013-14  
+ operating expenditure in 2013-14)

# Unique number of customers

Based on the household customer numbers from business plan table R3  
(connected properties less void properties)

Sum of all households connected

Water and sewerage households connected (metered and unmetered)  
will be adjusted for economies of scope

Unique customers = water only customers  
+ sewerage only customers  
+ (economies of scope adjustment x water and  
sewerage customers)

# Economies of scope adjustment

Economies of scope adjustment is made to customer numbers of dual service customers as costs of serving a dual service customer are greater than serving a single service customer, but less than two single service

$$\text{Economies of scope} = P_{CW} + (1 - P_{CW}) \left( \frac{B_W + B_S}{B_W} \right)$$

Where:

$$P_{CW} = \frac{\text{WOC costs for per customer drivers}}{\text{Total WOC costs}}$$

$B_W$  = average total bill (water)

$B_S$  = average total bill (sewerage)

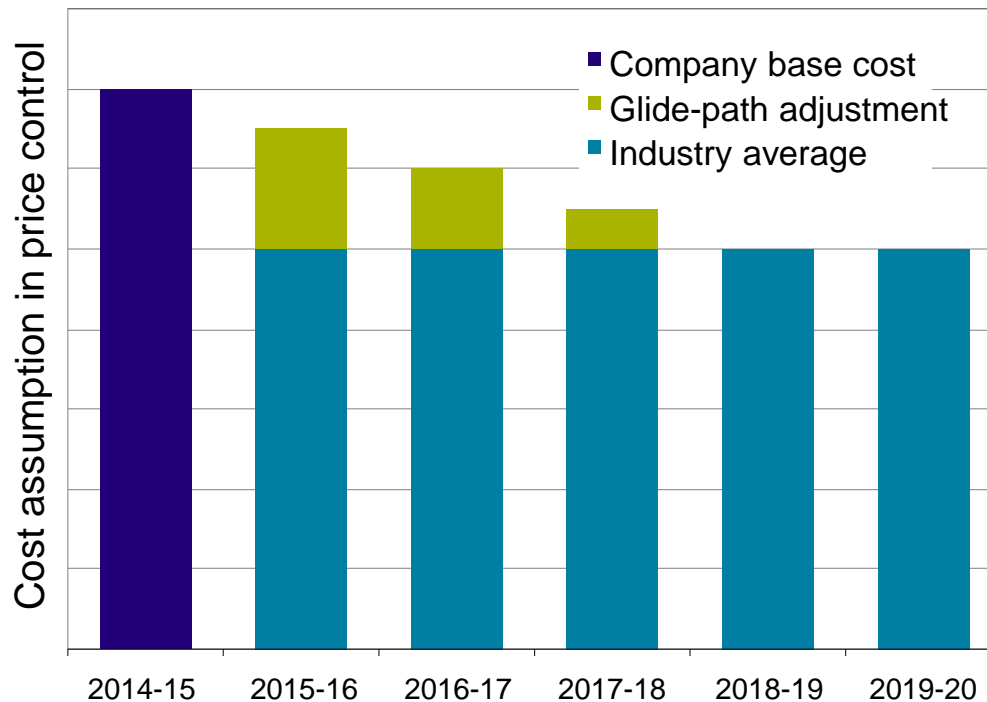
Since 2013-14 average bills are £202 for sewerage and £186 for water this becomes:

$$\text{Economies of scope} = 2.086 - 1.086 \times P_{CW}$$

# Calculating ACTS

ACTS is calculated using an unweighted average of all companies' unmeasured CTS

Efficiency challenge is difference between unmeasured ACTS and the companies' specific unmeasured CTS



The efficiency challenge applies to all companies with CTS above the unmeasured ACTS, which is applied using a three year glide-path

We will set the glide-path as a straight line

## Additional adjustments to the unmeasured CTS

After applying the efficiency challenge (if applicable) to the CTS we will then:

Subtract remaining depreciation for assets included in the RCV for each year of the price control. This will avoid double recovery of costs

We will then take into account any company specific adjustments that we allow to arrive at the allowed costs per customer that the company can recover

# Numerical example

	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
Allowance for future depreciation (£m)	0.7					
Total costs (£m)	20.7					
Customer numbers (millions)	1					
CTS (£ per customer)	20.7					

Costs excl metering costs

# Numerical example

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
ACTS (£ per customer)	19.8					
Efficiency challenge (£ per customer)	0.9	0.225	0.45	0.675	0.9	0.9
CTS (£ per customer) (before adjustments, incl legacy depreciation)		20.475	20.25	20.025	19.8	19.8
CTS (£ per customer) after removing legacy depreciation per customer		19.475	19.75	20.025	19.8	19.8
Allowed company specific adjustment (£ per customer)		2	2	2	2	2
Allowed recoverable costs £ per unmeasured customer		21.475	21.75	22.025	21.8	21.8

# ACTS for measured customers

The additional cost of serving metered customers will be subject to an ACTS calculation and efficiency challenge for all those with above average CTS

**There will be a separate calculation for the additional cost of serving:**

A measured water only customer

A measured sewerage only customer

A measured dual service customer

This is based on the additional metering cost lines 15-17 in business plan table R3



# ACTS for measured customers

Additional metering CTS (for each type) is simply metering expenditure divided by corresponding number of customers

ACTS is an unweighted average

It is possible to have an efficiency challenge for serving one type of measured customer but not another

# Numerical example

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Total retail metering expenditure – water only customers (£m)	4					
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

# Revenue per customer

Net margins will then be applied to the recoverable costs per customer to calculate an allowed revenue per customer

We will then multiply these by the corresponding number of connected customers (unique customers ie adjusted for economies of scope) to arrive at the allowed revenue



### 3. Non-household default tariffs

# Clarifications on costs

Total operating expenditure for non-household retail (table R4 Line 1) includes:

Doubtful debts

Debt management costs

Uncontrollable input costs should **not** be included in the costs for non-household retail

Retail cost numbers and default tariff charges should be submitted based on historic costs

If companies consider that uncontrollable input costs exist then they should separately provide clear and compelling evidence to support their claims that additional costs would be incurred as a result of input price pressures

If the evidence is persuasive, we will take the risk posed by these costs into account in setting the level of net margin

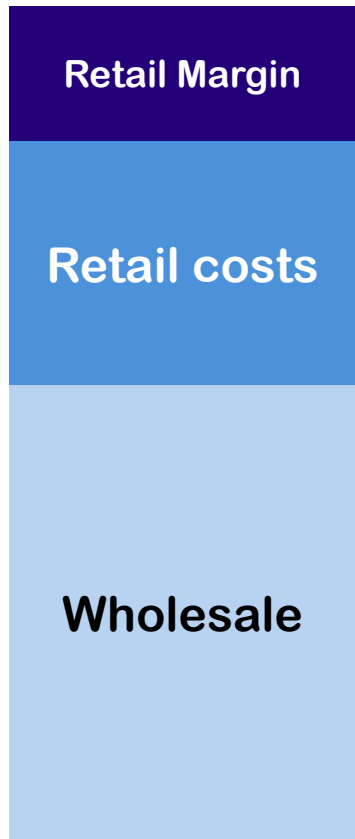
# Net margins

The net margins that we ask for in table R5 are based on total non-household (or household) retail revenue (including retail costs and wholesale revenue)

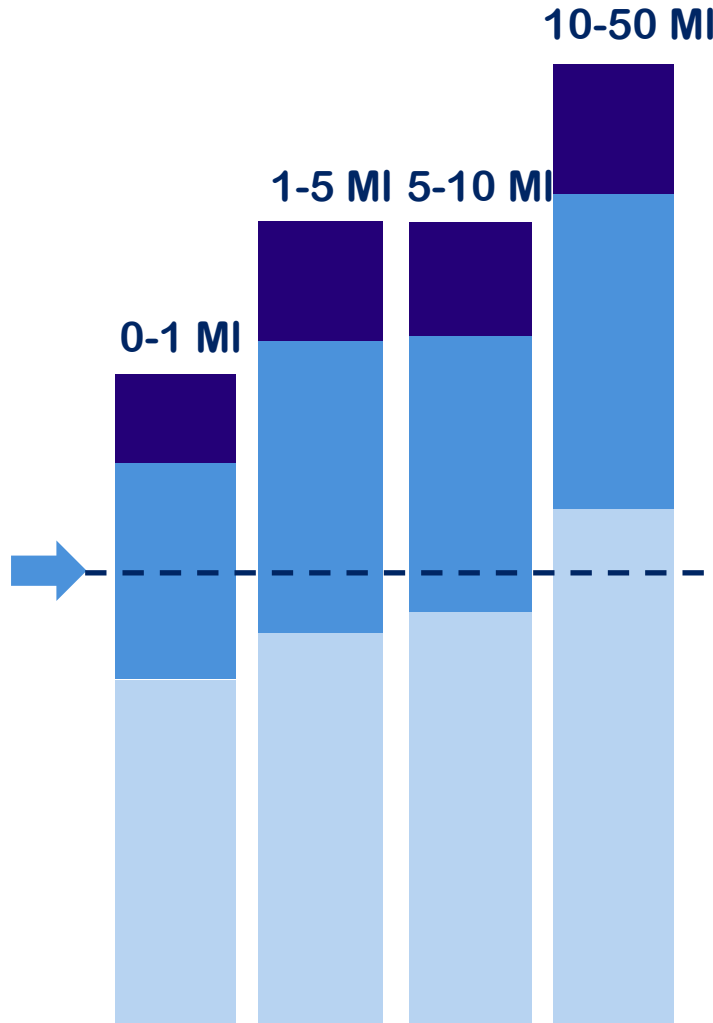
We are **not** asking for a markup on costs

# Non-household price control

## 1. Total non-hh revenue



## 2. Average revenue per customer (banded by tariff)



We are setting average revenue per customer by customer group. By customer group we mean tariff band. Companies can propose tariff bands with their default tariffs.

Average revenue controls mean that if companies lose customers they will lose revenue.

The price control is on a per customer basis, therefore there is no reason to forecast competition losses into the figures that are submitted

# Non-household default tariffs

Default tariffs will be a backstop form of protection for customers

Companies must offer their default tariffs however companies are free to offer alternative tariffs

Companies still have flexibility to adjust wholesale charging structures, only default tariff charging structures will be rigid





#### 4. Company-specific adjustments

# Company specific-adjustments

**In the methodology consultation we said that we would consider applications for company specific adjustments that meet three criteria:**

- Has a material impact on their costs

- Is beyond management control (having taken all possible steps to control it)

- Impacts the company in a materially different way to other companies

We also said that we would make adjustments for differences in the level of metering

## Companies might seek specific adjustments for things like:

Adjustments for bad debt (e.g. due to deprivation, size of bills/wholesale charges, etc)

Input price inflation

There is also an opportunity to seek new capex in ACTS but this will be dealt with differently in RBR expenditure test (and not subject to 3 criteria)

## Submitting company-specific adjustments

Companies have been asked to exclude company specific adjustments from the majority of cost lines and include them in lines 13 and 14 of table R3 for households

Companies proposing any specific adjustments should have these broken down individually in commentary along with supporting evidence and justification

Depreciation for new capex should be included in line 3 NOT included with company specific adjustments

# Submitting company-specific adjustments

## R3 – Information to set the household ACTS control

Company specific adjustments should **not** be included in block A

Line description	Item reference	Units	DPs	2010-11	2011-12	2012-13	2013-14
<b>A Expenditure</b>							
1 Total operating expenditure (excluding exceptional items)	R3001	£m	3				
2 Total depreciation of assets included in RCV (assets existing before AMP6)	R3002	£m	3				
3 Total depreciation of assets that are not included in RCV (AMP6 or later assets)	R3003	£m	3				
4 Debt management	R3004	£m	3				
5 Doubtful debts	R3005	£m	3				

Depreciation for new retail capex goes here in line 3. This **will** be included in the ACTS calculation IF we deem it reasonable to allow it in PR through RBR process

# Submitting company-specific adjustments

Company specific adjustments go here in block C. These lines should be totals for all expenditure that is excluded from the ACTS

C	Operating expenditure and depreciation – excluded from ACTS								
13	Operating expenditure – excluded from ACTS	R3013	£m	3					
14	Total depreciation of assets that are not included in RCV – excluded from ACTS	R3023	£m	3					

Do not forget to include a breakdown of the numbers in the commentary, along with a detailed explanation and evidence showing how you meet the criteria

# Including adjustments in the household price control

Adjustments will not be included in the costs used for calculating the ACTS

We will add these back on to the companies' allowed cost recovery after applying the efficiency challenge

Therefore adjustments will not be subject to the efficiency challenge on ACTS but the amount allowed will form part of this test

They will have to meet the three criteria or they will not be allowed (or partially allowed)

We will use benchmarks for RBR test in this area and consider quality of evidence provided



## **Forthcoming consultations**

Charging issues

2015-20 SIM approach

## **Forthcoming information notices**

SIM scores for 2011 to 2013

Pension deficit recovery costs

Retail definition