March 2014

2014 price review cost allocation for retail and wholesale price controls

About this document

This document describes a set of cost allocation rules for each of the monopoly water and sewerage and water only companies in England and Wales. These rules set out a standard set of cost drivers that companies must use for allocating their 2013-14 costs for the purpose of setting the wholesale and retail price controls, and also the household retail and non-household retail price controls from 2015-20.

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1. Background

Ofwat introduced accounting separation in 2009-10. Since then, we have consulted on and refined our proposed approach for allocating costs between different company activities based on feedback from stakeholders and market participants.

In May 2013, we published our 'Targeted review of accounting separation cost allocations', which considered whether companies' accounting separation data were sufficiently robust for us to set retail price controls at the 2014 price review (PR14). In particular, our review focused on the boundaries between the retail and wholesale business units and between household and non-household customers. Getting these boundaries right – and ensuring that companies allocate their costs in a consistent manner across these boundaries – is particularly important for the following reasons.

1. The UK Government's Water Bill includes plans to allow all non-household customers in England to choose their supplier for customer-facing ('retail') water and wastewater services by April 2017. Delivering these national retail markets across a series of regional companies providing monopoly wholesale services to competitive retailers will require robust and consistent allocation of costs – otherwise, the relevant retail markets may be affected differently in different regions (for example, because companies use materially different cost drivers or allocation approaches). This could lead to an inconsistent operation of those markets, or some non-household customers not being able to participate effectively in them. In future, to deliver a level playing field in competitive retail markets, companies will need to ensure that they are compliant with their obligations under competition law. Companies and their Boards will need to be sure that their non-household retail operation is able to operate as a viable and sustainable stand-alone business unit and there will be obligations to ensure that wholesalers treat their own and other retailers without preference. This may lead them to take forward some further separation of their non-household retail operations – indeed, some have already done this and many others set out plans to do so in their PR14 business plan submissions to us in December 2013.

2. Many of our regulatory tools under the price controls are comparative – in particular, our 'average cost to serve' (ACTS) incentive seeks to drive efficiency across companies by forcing those with above average household retail costs to reduce them down to an efficient level. Since these tools are comparative, it is important that we can compare similar definitions of costs – 'apples with apples' – otherwise our regulatory incentives may be applied unfairly across companies.

To deliver a robust and consistent approach to cost allocation, we included a retail test on this as part of our risk-based review process for PR14. But, in general, companies' business plans did not contain sufficient information to allow us to test cost allocation consistently. So we issued a request seeking additional information on the approach they took to allocating costs across their business.

The responses we received to our additional information request revealed that some companies had used the cost drivers that we had set out in 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology statement') in their December business plans, but that others had used alternatives.

In some cases, this additional information suggested that the alternatives companies had used were less reflective of how costs are driven by the different business activities. We highlighted instances where these companies needed to carry out further work to improve cost allocation in 'Setting price controls for 2015-20 – pre-qualification decisions', which we published on 10 March.

But in some cases, companies used better and more cost-reflective cost drivers for specific costs, which improved on the general cost drivers indicated in our guidance. Consequently, in our risk-based review exercise we passed all companies that had complied with our guidance in developing their business plans, or had used a more cost-reflective cost driver for specific costs – which was the spirit of what this test was trying to achieve.

That said, having reviewed business plan submissions, in some cases it is clear that if companies were to use different cost drivers for specific individual cost items in this way, it could result in material changes in the overall amounts of costs being allocated to the different retail price controls. This suggests that, in order to finalise actual price controls, there is a clear need for consistent cost drivers to be used at a more granular level of costs than we set out for carrying out the initial risk-based review of business plans. It is also clear from the submissions that to support more detailed guidance, we could use the better, cost-reflective drivers that some companies have already employed in their business plans for this purpose.

In light of this experience, we consider that it is necessary to issue these more detailed cost allocation rules for finalising price controls in PR14 – and, in particular, to require companies to adopt a consistent set of cost drivers to allocate their costs.

2. Interactions

The Open Water programme has been taking forward work to prepare for the implementation of the new non-household retail market in April 2017. In January, Open Water launched a consultation on a market blueprint, to which many stakeholders have responded. In developing our proposals, we have been mindful of the direction and ongoing work of that programme and the responses from stakeholders to the consultation.

Similarly, on 1 March, companies re-submitted more detailed information to allow us to set default tariffs, as set out in IN 14/01, 'Adapted approach for default tariffs', which we published in January. Drawing on these further inputs, **we intend to issue new guidance on setting default tariffs for the non-household retail controls on 4 April**. Where that guidance sets out cost drivers for companies to use in setting their default tariffs, we expect it to be consistent with the rules set out here.

The changes proposed in this document will not affect the regulatory accounts for 2013-14 or 2014-15, which should continue to be prepared under existing regulatory accounting guidelines (RAGs) and supporting information notices. For the purposes of cost allocation in the 2014-15 regulatory accounts, companies should refer to IN 14/05, 'Expectations for company reporting 2013-14 – regulatory accounts, accounting separation and performance information'. We expect to consult in the autumn on changes to the RAGs governing regulatory financial reporting in the new price control period from 2015, consistent with the basis of setting price limits covered in this document. We will consider these issues again when we publish that consultation.

3. Proposed cost drivers

We are proposing the following cost drivers for allocating costs between both the wholesale and retail and the household retail and non-household retail parts of the business for 2015 price controls onwards.

Generally, we have sought to select cost drivers that improve cost reflectivity for the allocation of costs at the level of granularity covered in these rules. We expect most companies' systems to be able to provide information relevant to the 2013-14 basis of the costs concerned and appropriate for setting price controls (given the time constraints between now and final determinations in December).

But we recognise that in seeking to apply these cost drivers, in some cases companies may need to collect new information or change their data capture systems to supply complete information. Where this is the case, we would expect them to take a sampling approach in the time available, and to explain clearly the approach taken and the results of that approach in their future submissions; later this year, we will consult on the requirements for regulatory financial reporting of actual costs from 2015-16.

In seeking a clear and robust overall allocation, the ideal approach is for costs of a given type to be fully and directly attributed to the relevant price control elements, as we indicated in our earlier business planning guidance. Indeed, in its business plan one company had already achieved a near full attribution of all its costs – in particular, to separate household and non-household retail cost centres: that company received an 'exceptional' score for the relevant risk-based review test. **Therefore, the cost drivers noted below should only be used to allocate costs where such direct attribution is not possible.**

We note that compliance with these charging rules does not override companies' obligations under competition law and should we receive a complaint under the Competition Act 1998 (CA98) in relation these rules then we reserve the right to exercise our discretion to investigate that matter under Ofwat's CA98 powers of investigation.

3.1 Proposed cost drivers – wholesale versus retail

Where possible, operating costs should be directly attributed between the retail and wholesale price controls. For some of the cost types in table 1 below, it may be possible to directly attribute some but not all of the costs. Where this is the case, the costs that can be directly attributed should be directly attributed to the relevant retail or wholesale controls, with the remainder of the costs allocated using the cost drivers in the table.

Table 1 Rules for cost allocation between wholesale and retail price controls

Cost type	Wholly or partly in retail?	Part in retail	Part in wholesale	Cost driver to be used (only where costs cannot be directly attributed)
Customer services:				
Billing	Wholly in retail			
Payment handling, remittance and cash handling	Wholly in retail			
Vulnerable customer schemes	Wholly in retail			
Non-network customer enquiries and complaints	Wholly in retail			
Network customer enquiries and complaints	Wholly in retail			
Other customer services	Wholly in retail			
Debt management	Wholly in retail			
Customer doubtful debts	Wholly in retail			
Meter reading	Wholly in retail			
Other operating costs:				
Disconnections and reconnections	Partly in retail	Decision and administration	Physical activity	
Demand-side water efficiency initiatives	Wholly in retail			

Cost type	Wholly or partly in retail?	Part in retail	Part in wholesale	Cost driver to be used (only where costs cannot be directly attributed)
Customer-side leaks	Wholly in retail			
Charitable trust donations	Wholly in retail			
Other operating costs	Partly in retail			In order of preference: 1. Time (based on timesheets). 2. Another more appropriate cost driver (depending on the nature of cost) or where time basis is not possible and there is not an obvious cost driver. 3. FTEs.
Other direct costs	Partly in retail			
General and support expenditure, including:				
IT costs	Partly in retail			An appropriate cost driver depending on the nature of IT costs, and where there is not an appropriate cost driver, would be the number of computers.
Motor vehicle costs	Partly in retail			Number of vehicles.
Finance, HR, payroll, executive team, general management	Partly in retail			In order of preference: 1. Time (based on timesheets). 2. FTEs.
Facilities, building/grounds maintenance	Partly in retail			Floor space.

Cost type	Wholly or partly in retail?	Part in retail	Part in wholesale	Cost driver to be used (only where costs cannot be directly attributed)
Insurance costs	Partly in retail			FTEs for employers/employees liability or more appropriate cost driver for other types of insurance.
Other general and support costs	Partly in retail			In order of preference: 1. Appropriate cost driver (based on nature of cost) or where there is not an obvious cost driver. 2. FTEs.
Other business activities (regulation costs)	Partly in retail			1/9th to retail for water and sewerage companies, 1/5th to retail for water only companies.
Developer services	Partly in retail	Providing developer information and administration for new connections	All other developer services (that is, those not in retail)	
Local authority rates:				
Local authority rates	Partly in retail			Floor space.
Cumulo rates	Partly in retail			GMEAV.

3.2 Proposed cost drivers – retail household versus retail non-household

Where possible, retail operating costs should be directly attributed between the household and non-household price controls. For some of the cost types in table 2 below, it may be possible to directly attribute some but not all of the costs. Where this is the case, the costs that can be directly attributed should be directly attributed to the household or non-household retail controls, with the remainder of the costs allocated between the two using the cost drivers in the table.

Table 2 Rules for cost allocation between household and non-household retail price controls

Cost type	Entirely in household/ non-household, or split between household/ non-household?	Cost driver to be used (only where costs cannot be directly attributed)
Customer services:		
Billing	Split	Number of bills raised.
Payment handling, remittance and cash handling	Split	Number of payments received.
Vulnerable customer schemes	Entirely in household	
Non-network customer enquiries and complaints	Split	In order of preference: 1. Time spent on non-network customer enquiries and complaints. 2. Volume of non-network customer enquiries and complaints.
Network customer enquiries and complaints	Split	In order of preference: 1. Time spent on network customer enquiries and complaints. 2. Volume of network customer enquiries and complaints.

<table>
<tr><th>Cost type</th><th>Entirely in household/ non-household, or split between household/ non-household?</th><th>Cost driver to be used (only where costs cannot be directly attributed)</th></tr>
<tr><td>Other customer services</td><td>Split</td><td>In order of preference:
1. Appropriate cost driver (based on nature of cost) or where there is not an obvious cost driver.
2. Customer numbers.</td></tr>
<tr><td>Debt management</td><td>Split</td><td>Debt outstanding for more than 30 days (that is, not current debt).</td></tr>
<tr><td>Customer doubtful debts</td><td>Split</td><td>Directly attributable on a customer-specific basis.</td></tr>
<tr><td>Meter reading</td><td>Split</td><td>In order of preference:
1. Time (based on timesheets).
2. Number of meter reads factored by scheduling an allowance for average time taken.
3. Number of meter reads.</td></tr>
<tr><td colspan="3">Other operating costs:</td></tr>
<tr><td>Disconnections and reconnections</td><td>Entirely in non-household</td><td></td></tr>
<tr><td>Demand-side water efficiency initiatives</td><td>Split</td><td>Direct allocation where initiatives are specific to household or non-household, otherwise customer numbers.</td></tr>
<tr><td>Customer-side leaks</td><td>Split</td><td>Directly attributable on a job-specific basis.</td></tr>
<tr><td>Charitable trust donations</td><td>Entirely in household</td><td></td></tr>
<tr><td>Other operating costs</td><td>Split</td><td rowspan="2">In order of preference:
1. Time (based on timesheets).
2. Another more appropriate cost driver (depending on nature of cost) or where time basis is not possible and there is not an obvious cost driver.</td></tr>
<tr><td>Other direct costs</td><td>Split</td></tr>
</table>

Cost type	Entirely in household/ non-household, or split between household/ non-household?	Cost driver to be used (only where costs cannot be directly attributed)
		3. Customer numbers.
General and support expenditure, including:		
IT costs	Split	Customer numbers.
Motor vehicle costs	Split	
Finance, HR, payroll, executive team, general management	Split	
Facilities, building/ grounds maintenance	Split	
Insurance costs	Split	
Other general and support costs	Split	In order of preference: 1. Appropriate cost driver (based on nature of cost) or where there is not an obvious cost driver. 2. Customer numbers.
Other business activities (regulation costs)	Split	
Developer services	Entirely in non-household	
Local authority rates:		
Local authority rates	Split	Customer numbers.
Cumulo rates	Split	

4. Additional guidance on definitions and allocation issues

To facilitate the use of these cost drivers for the purpose of revising business plan information, we set out some additional guidance below on the definition and allocation of specific cost items.

4.1 Definition of customer numbers

To ensure consistency with the approach being taken for the ACTS for setting retail household controls, 'customer numbers' as referred to in tables 1 and 2 above are equal to:

- 1.0 for single-service (water or wastewater only) customers; and
- 1.3 for dual-service (water and wastewater) customers.

4.2 Definition of customer type (household/non-household)

In appendix 5 of our methodology statement, 'Guidance on business plan tables', we confirmed that, for the purposes of separating retail costs, companies should continue to use the following regulatory reporting definition of customers, which we used previously in the June return.

- **Households** – these are properties used as single domestic dwellings (normally occupied), receiving water for domestic purposes which are not factories, offices or commercial premises. These include cases where a single aggregate bill is issued to cover separate dwellings having individual standing charges. (In some instances, the standing charge may be zero.) The number of dwellings attracting an individual standing charge and not the number of bills should be counted. Exclude mixed/commercial properties and multiple household properties – for example, blocks of flats having only one standing charge. Where companies issue an assessed charge to a property because metering is not possible or is uneconomic, then these properties should be classified as unmeasured.

- **Non-households** – these are properties receiving water for domestic purposes but which are not occupied as domestic premises, or where domestic dwellings are combined with other properties, or where properties are in multiple occupation but only have one standing charge. In this case, it is the number of bills that should be counted.

The Open Water programme is currently carrying out a data pilot exercise that is seeking to develop a common understanding of the contestable market going forwards. This exercise is considering the definition of the non-household market in England according to business rated premises as defined by the Valuation Office Agency (VOA), but with the exemptions defined in section 8 of the VOA guidance included in the same market dataset.

4.3 Definition of FTEs

For the purposes of cost allocation FTEs (or ‘full-time equivalents’) should include all full-time staff, but also directly employed contractors or temporary staff.

4.4 Capitalisation of developer services costs

In our ‘Note of the retail price control workshop held on 26 September’, we confirmed that the wholesale element of developer services expenditure may be capitalised within wholesale costs for business plan purposes, in line with companies’ capitalisation policies and applicable accounting standards. But companies should not in any event capitalise the retail element of developer services, as there is no asset relevant to the setting of retail controls against which to capitalise these costs. Therefore, in all cases, the retail element of developer services expenditure should be treated as operating expenditure.

4.5 Allocation of capital costs and depreciation

In line with the treatment of operating costs outlined above, where possible, capital expenditures and associated depreciation should be directly attributed between the retail and wholesale price controls, and retail expenditures between the household and non-household controls.

Where an asset is utilised in more than one price control, it should be recorded in the price control or business unit of principal use with recharges made to other business units that use the asset. Recharges should reflect the proportion used by each asset. The basis of the recharge should relate to the asset. For example:

- finance software is allocated based on number of licences;
- leasehold and freehold property is allocated based on floor space; and
- land is allocated on based on use/area.

5. Next steps

All companies will be expected to have allocated their 2013-14 costs in line with these rules for the purposes of us making our final determinations in December for the period 2015-20, including updating the allocations of projected costs already provided in their business plans where required for earlier draft determinations.

5.1 Pre-qualified companies

Pre-qualified companies may choose to:

- re-submit (with relevant assurance) their existing business plan information in line with these new cost allocation rules by **11 April**, in which case any April draft determination would be based on this new and revised information; or
- re-submit their revised information by **27 June**, which would allow us to update the industry ACTS used for household retail controls alongside consistent non-household retail draft determinations for all companies, which we are publishing in August.

The non-household retail draft determinations will reflect our default tariffs guidance, which we intend to publish on 4 April. We would expect these companies to submit revised business plan tables R3 and A19 with some commentary explaining:

- the change in costs from those submitted in December business plans; and
- any change in wholesale costs.

5.2 Companies seeking a June draft determination

These companies may choose to:

- re-submit their information in line with these new rules by **2 May**, in which case any June draft determination would be based on this new and revised information; or
- re-submit their revised information by **27 June**, which would allow us to update the industry ACTS used for household retail controls, alongside consistent non-household retail draft determinations for all companies, which we propose to publish in August.

The non-household retail draft determinations will reflect our default tariffs guidance, which we intend to publish on 4 April. We would expect these companies to submit revised business plan tables R3 and A19, as well as any revised wholesale business planning tables with commentary explaining the change in costs from those submitted in their December business plans.

5.3 Companies seeking an August draft determination

We would expect these companies to re-submit their revised information by **27 June**, which would allow us to set a draft determination in August, including a non-household retail draft determination, reflecting our default tariffs guidance which we intend to publish on 4 April. We would expect these companies to submit revised business plan tables R3 and A19 on 27 June, as well as any revised wholesale business planning tables with some commentary explaining the change in costs from those submitted in December business plans.

5.4 All companies

By **27 June**, all companies are expected to submit some commentary explaining the variance between their costs based on this new guidance and those expected to be reflected in their published audited 2013-14 regulatory accounts (which we expect to be published by 15 July as usual).

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

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Photograph © Stockvault
Printed on 75% minimum de-inked post-consumer waste paper
March 2014

ISBN 978-1-908116-64-2

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.

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