April 2014

Setting price controls for 2015-20 – guidance for companies on producing default tariffs

OFWAT

About this document

This document provides further guidance to companies for developing their default tariff proposals for submission by 27 June 2014.

Contents

1. Background

On 2 December 2013, companies submitted their business plans. However, there were a number of issues with the default tariffs proposed in these plans. As we stated in IN 14/01, 'Adapted approach for default tariffs', because of the widespread nature of the issues, we decided to remove default tariffs from the risk-based review and to adopt an adapted process. Through this process, we sought further details from companies by 1 March on the basis of the default tariff proposals they had put forward in their business plans.

Having considered this additional information, this document provides all companies with further guidance around completing the revised R4 retail data table[1], which we require by **27 June 2014** in order to set out our proposals for price controls in August, along with a supporting narrative explaining their approaches. Draft determinations issued in April and June will not include proposals for default tariffs.

The IN 14/01 had initially envisaged a deadline of 15 May for companies to submit the revised 'R4' table to us. However, following discussions with companies, we have decided to extend the length of time companies will have to populate the revised R4 table to ensure that high-quality submissions are produced that reflect the guidance set out below.

The new date for completing the revised 'R4' data table in line with this guidance is the same date that we require a range of other data tables from companies. Therefore, the default tariff submissions must have a consistent level of assurance and reconciliation to other tables submitted, as well as reconciling to externally audited actual separate accounts for 2013-14 to be published by companies on 15 July.

The R4 data table has been adapted to include more built-in cross-checks that should help reduce the scope for calculation errors. The guidance below should also provide further clarification to companies for producing the necessary supporting information.

[1] The 'R4' data table contains key information of companies' proposals that we require in order to develop draft determinations.

2. Default tariffs

2.1 Overview

The business plan submissions reflected a range of understanding of our approach to default tariffs (for example, when they would commence). For the avoidance of doubt, we have restated our approach to default tariffs below, and provided further detail.

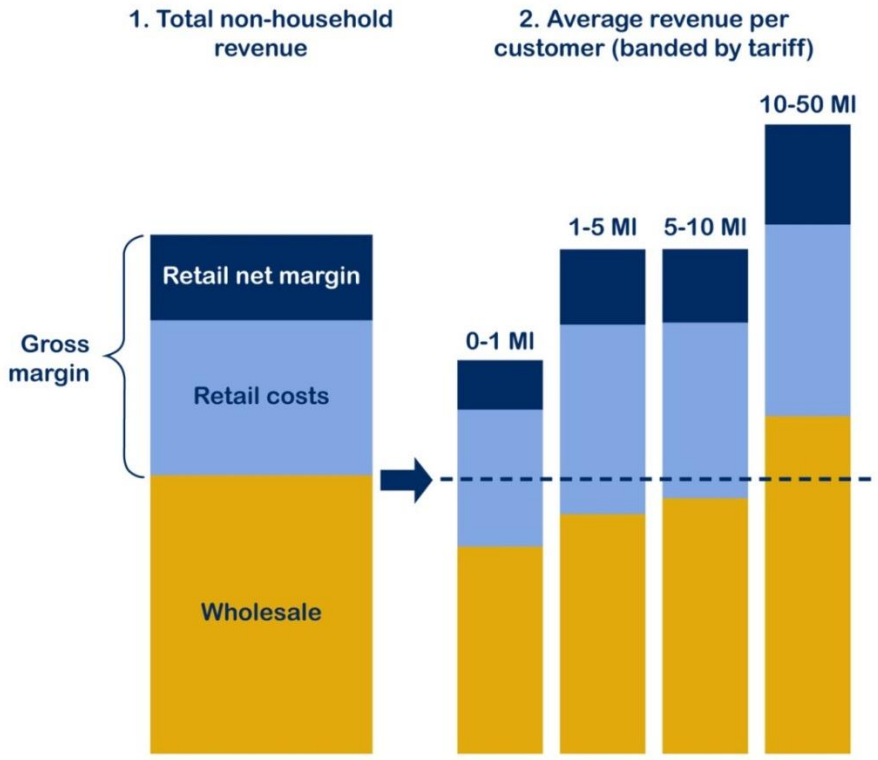
For non-household retail controls, we will adopt a gross margin approach, per customer. By this we mean our determinations will set out an allowed amount of retail revenue that will be added to the wholesale charge. The gross margin of allowed average revenue will comprise of retail costs and a net margin (see chapter 5).

We will set limits on the average revenue per customer for each customer type. We will use each company's proposed tariff structures to determine the different customer types according to bands.

The revenue controls will be based on an assessment of the appropriate level of costs associated with each customer type, plus a net margin.

We will set out draft non-household retail revenue controls as part of the 29 August draft determinations. This will include draft controls for any companies assessed as enhanced. We will issue final determinations for all companies by 12 December.

Figure 1 Revenue by tariff band



Companies will be accountable for developing charges that comply with the average revenue controls. The charges that they set to comply with the average revenue controls are the ‘default tariffs’.

Default tariffs are a form of ‘back-stop’ protection for customers. In competitive environments, it is normal for market participants to offer a range of potential tariffs to customers reflecting their different circumstances.

So, companies may wish to offer their customers alternatives to the default tariffs – but the default tariffs reflect a capped level of average revenue for companies to deliver their regulatory and legislative obligations, and must always be offered. In Scotland, default tariffs for non-household customers have been used since 2008, with customers being free to contract different service levels at different prices (examples of gross margins by customer type in Scotland are included in appendix 1).

All non-household customers will begin the new control period (starting on 1 April 2015) on the 'default tariffs'. The tariffs that align to the average revenue controls are the 'default tariffs' and provide the 'default' position from which customers have a choice of moving away from.

If companies wished to offer tariffs to customers that did not comply with the average revenue controls, then they are free to do so either by:

- not taking up their full allowed average revenue limit under the default tariff for that customer class (while ensuring that they stay compliant with all of their regulatory and legislative obligations); or
- offering alternative tariffs to customers. In such circumstances, customers would need to actively choose to switch away from the default tariffs to such arrangements (as opposed to the company unilaterally transferring them).

Before charges come into effect, and throughout the 2015-20 price control period (AMP6), companies will be allowed to change the charging variables of the default tariffs (both in terms of the number of variables and the relative balancing between them), but the default tariffs must comply with the average revenue controls.

For the avoidance of doubt, companies are responsible for ensuring that they are compliant with their duties and obligations (including competition law). In offering alternative tariffs, companies will need to further consider whether their proposals create any legal risks.

2.2 What will Ofwat set?

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'final methodology statement'), we said that we will need to determine the:

- **different customer types** for which we will set default tariffs; and
- **appropriate average retail revenue** per customer for each customer type.

We confirmed our approach will be to use each company's proposed tariff structures to determine the different customer types for which default tariffs will be set. This is a simpler and more proportionate approach than setting national customer types or tariffs, and it will minimise initial incidence effects on prices for different customer groups.

We also confirmed that the controls will include a net margin to secure efficient financing of capital employed in providing non-household services, encourage efficient entry and remunerate efficiently incurred risk (see chapter 5).

Table 1 below sets out illustrative examples of the average revenue controls.

Table 1 Illustrative examples of average revenue controls

Tariff band	Tariff A	Tariff B	Tariff C
Average revenue per customer	£30 + 1.5% net margin	£50 + 2.5% net margin	£80 + 3.5% net margin

That is, the total amount of revenue that can be recovered in a given year from 'tariff B' customers is the projected wholesale revenue for that band, plus £50 multiplied by the number of customers, and the 2.5% net margin. It is then for companies to set charges that comply with that level of revenue.

We set out an example below.

Forecast wholesale charge for tariff band B = £25 million

Number of customers = 100,000

$$\text{Total tariff revenue} = \left(\frac{(£25\text{m} + (£50 \times 100{,}000))}{(1-2.5\%)}\right) = £30.77 \text{ million}$$

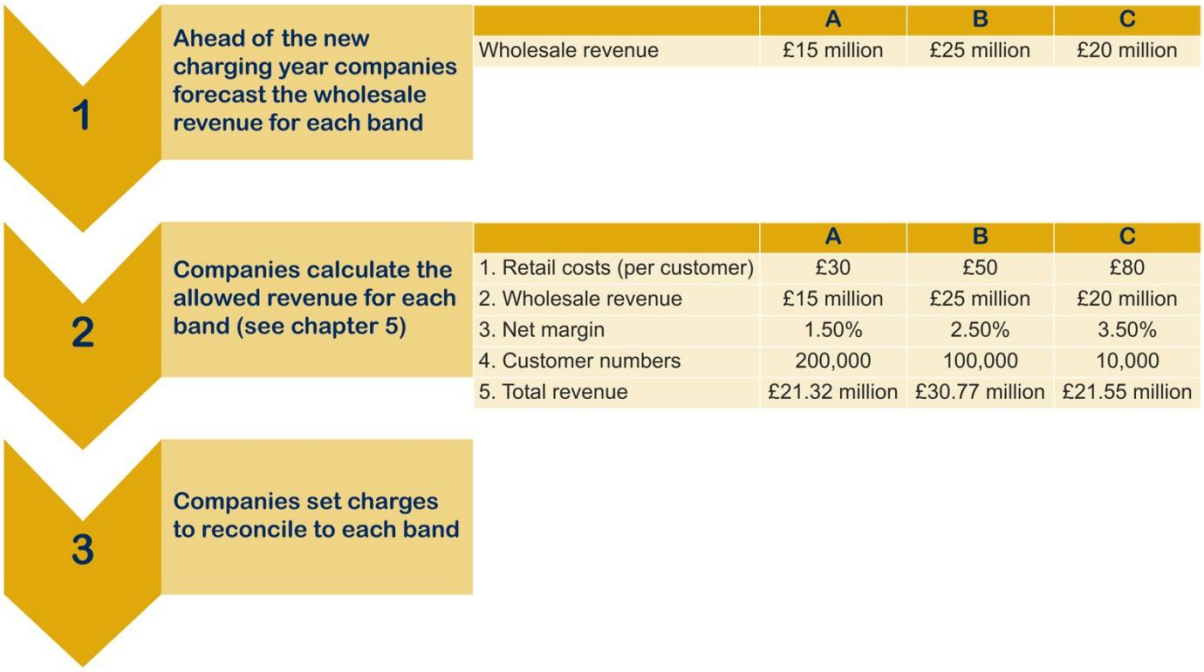
Companies will then need to set wholesale charges that reconcile to the £25 million figure, and end user charges (the default tariffs) that reconcile to the £30.77 million figure.

For further details on the net margin, see chapter 5.

The net margins will be set as percentage figures to be applied each year to the annual forecast wholesale revenue and the retail cost component as shown above. This is because the underlying wholesale charges may change year-on-year (because of inflation, flexibility of adjusting revenue between years, and other within-period adjustments). This potentially leads to working capital requirements changing year-on-year. Consequently, if the net margins were set as absolute values, such changes at the wholesale level could lead to insufficient net margins.

Figure 2 sets out a process diagram which includes an indicative example for the above tariff bands.

Figure 2 Process diagram for indicative example of tariff bands



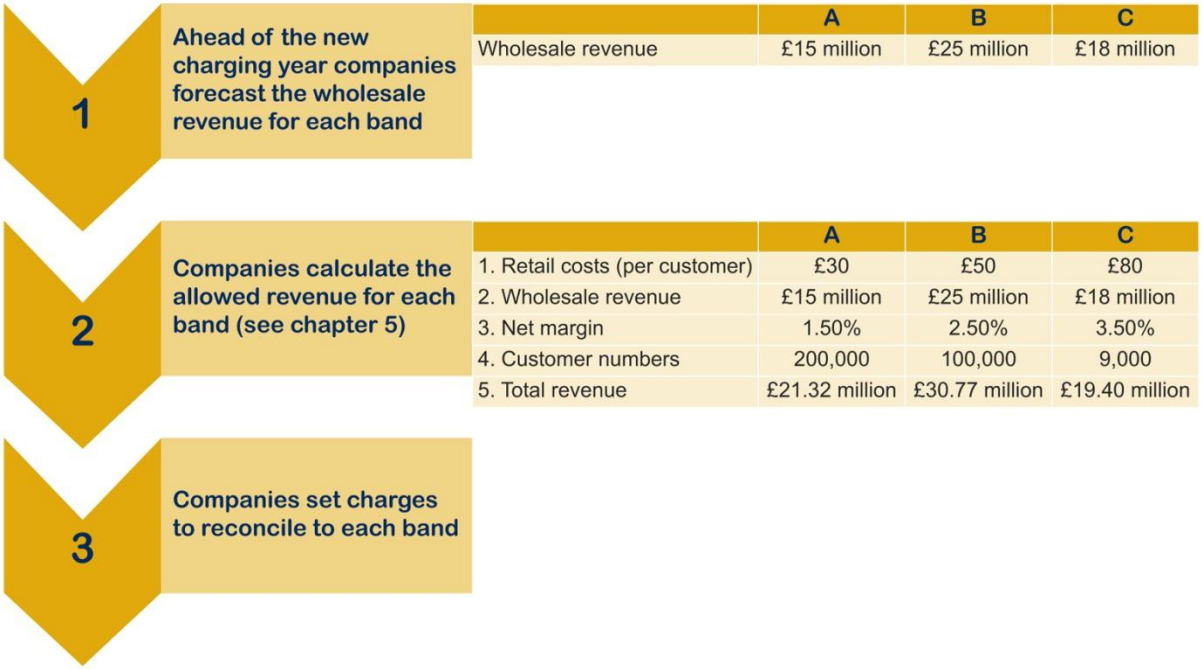
	A	B	C
Wholesale revenue	£15 million	£25 million	£20 million

	A	B	C
1. Retail costs (per customer)	£30	£50	£80
2. Wholesale revenue	£15 million	£25 million	£20 million
3. Net margin	1.50%	2.50%	3.50%
4. Customer numbers	200,000	100,000	10,000
5. Total revenue	£21.32 million	£30.77 million	£21.55 million

If a company starts gaining or losing customers from the default tariffs, the wholesale revenue figure used in the default tariff revenue calculation will need to be adjusted to reflect the wholesale revenue that is relevant to the customers on default tariffs.

For example, if 1,000 ‘tariff C’ customers were to move away from the default tariffs (either by moving to a different tariff with the incumbent company or by switching to a different company), then the wholesale revenue associated with them would need to be deducted from the wholesale revenue used to determine the allowed revenue for the next year. We illustrate this in figure 3 below.

Figure 3 Process diagram for indicative example of tariff bands following customer losses



	A	B	C
Wholesale revenue	£15 million	£25 million	£18 million

	A	B	C
1. Retail costs (per customer)	£30	£50	£80
2. Wholesale revenue	£15 million	£25 million	£18 million
3. Net margin	1.50%	2.50%	3.50%
4. Customer numbers	200,000	100,000	9,000
5. Total revenue	£21.32 million	£30.77 million	£19.40 million

The charges that companies propose in R4 will provide us with an initial understanding of how they propose to recover the retail service revenue from customers within each band. For example, if a company excluded variable charges from R4 (that is, it opted for fixed charges only, reflecting the fact that most retail costs are fairly independent of demand within a given tariff band), it would reveal that the company's proposals are for all customers within the proposed band to receive the same gross margin.

We will not require companies to offer the charges proposed in R4 (after all, these relate only the retail service component). As we said in section 2.1, companies will be allowed to change the charging variables of the default tariffs (subject to complying with their duties, obligations, and the average revenue controls).

For the avoidance of doubt, while our final determinations will set out the average revenue controls with which companies must comply per tariff band, they will not place restrictions on how companies structure their charges (although there are certain types of default tariffs that will need to be offered – see chapter 4).

If, within period, we were to consider that there were significant risks to effective competition developing as a result of inappropriate revenue being allowed within a given tariff band, and that such concerns could not be addressed proportionately through alternative measures, we would seek to adjust the allowed average revenue within that tariff band to a level that we considered would enable effective competition to develop where appropriate.

3. Wholesale charges

In populating table R4, companies need to provide proposed wholesale revenue for each tariff band. These proposals will (in part) inform our view of working capital requirements for each band, and consequently the net margins that we set for the controls relevant to each band.

In proposing the level of wholesale revenue for each tariff band, companies will need to make some assumptions about wholesale charging structures, and projected volumes for each band.

We expect the process that companies use in developing proposals for the wholesale revenue for each tariff band to be an iterative one. That is, companies should be mindful whether the wholesale charges, when summated with the retail service charges in R4, create significant incidence effects[2]. If such effects seem likely in a given year, we suggest that companies explore options of re-balancing wholesale charges across the non-household tariff bands while remaining compliant with their wider licence obligations.

This may be considered to be in line with a pragmatic approach to limit incidence effects, with charges evolving over time to become more cost reflective.

This is perhaps closer to the 'combination' approach to splitting charges that we described in 'Wholesale and retail charges – a consultation', and similar (to an extent) to the approach used in Scotland where a top-down restriction was put in place so that no customer should see a retail charge increase of more than 1.5% real (5.7% nominal)[3].

Our expectations:

1. If assumed wholesale charging structures differ from existing tariff structures, for a clear justification to be provided why an alternative structure has been used to calculate the projected wholesale charge.
2. For companies to consider re-balancing the wholesale charges across the non-household tariff bands to limit the implication of any significant incidence effects.

[2] We will further discuss issues relating to bill stability when we consult on charging rules in line with the expected provisions of the Water Bill later in the spring.
[3] See: Commission decision paper number CP170-07

4. Structure of tariffs

4.1 New structures

In our final methodology statement, we confirmed that our proposed approach to setting default tariffs was to use each company's own proposed default tariff structure – which we considered would likely be based on their existing retail tariff structures – to determine the different customer types for which we would set default tariffs.

In their business plans, companies proposed many structures that were different from their existing tariff structures. While we do not disagree with the principle of new structures being proposed for use in the context of the new market arrangements being developed in line with the UK Government's proposals in the Water Bill, we are aware that using different structures could risk giving rise to unacceptable incidence effects for some customers. We would expect that where companies propose new structures, they carry out an impact assessment of any significant incidence effects.

Our expectations:

1. If new structures are proposed, for companies to explain clearly why they consider those structures to be appropriate.
2. If new structures are proposed, for companies to have considered the potential incidence effects.

4.2 Number of tariffs

Water only companies (WoCs) will need to provide default tariffs for non-household retail customers in their appointed areas for the following services.

- Metered water.
- Unmetered water.

Water and sewerage companies (WaSCs) will need to provide separate default tariffs for non-household retail customers in their appointed areas for the following services.

- Metered water.
- Unmetered water.
- Metered sewerage.
- Unmetered sewerage.
- Trade effluent.

For companies operating wholly or mainly in Wales, we require separate sets of default tariffs for customers above and below the 50 megalitre (Ml) threshold.

The services listed above include a range of sub-services. For example, sewerage covers foul sewerage, surface and highway drainage.

Some WaSCs did not propose a separate trade effluent default tariff in their business plans. The revenue for trade effluent is currently separated out in companies' accounts. It has some fairly distinct features from general sewerage retailing. So for the June submission, we will require WaSCs to propose separate trade effluent default tariffs

The median number of tariffs that WoCs proposed was five, and the median number that WaSCs proposed was 19. One company proposed more than 60 different default tariffs. While we do not consider that setting an absolute limit on the number of proposed default tariffs would be appropriate at this time, we do expect companies to consider whether proposing a large number of default tariffs is genuinely necessary, and to be aware of the potential effect on transparency that a large number of tariffs could have.

The possibility of having a single average revenue control for each service has been suggested previously. Where there is significant variability in the costs of serving customers, this is not appropriate as different customer types may require different net margins, and different retail costs to serve. As a result, companies need to propose different tariff bands. For further clarity, in appendix 2 we include an example of why a single average revenue control is not appropriate.

Most companies proposed different default tariffs for customers with different usage (for example, <10 Ml, 10-50 Ml, and >50 Ml). The approach to grouping varied significantly across the water sector. However, as enforcing standardisation in this area could cause significant incidence effects, and potentially reduce cost reflectivity in some cases, we are not proposing to require a single way of grouping customers at this stage.

Some companies included different default tariffs for different sub-company areas. This may or may not be necessary depending on the variability of costs between the areas. For example, the average revenue controls will include a figure derived from retail costs, and as such will reflect bad debt costs. Bad debt costs are, in part, a function of wholesale charges. So, if bad debt was to differ significantly across areas (because of differences in wholesale charges), then this could result in the average revenue controls not being suitably cost reflective. Companies with different sub-area wholesale charges, will need to decide whether a separate revenue control is required based on an assessment of the variability of their retail costs.

Also, if companies currently have any 'special agreements' for non-household retail customers that are significantly different in nature from existing standard charges – to the extent that a different approach to setting the associated default retail tariff is required – companies should also set out such different default tariffs (see section 4.5 for further details). We expect companies to apply the same approach of proposing tariffs where appropriate for any other bespoke services (such as providing raw water).

Our expectations:

1. For companies to have included distinct proposals for the services identified above in completing table R4.
2. For companies to explain why they have decided on the number of tariffs proposed.

4.3 Developer services

As we said in our final methodology statement, retailers will be responsible for arranging connections on behalf of developers, but the associated revenue and cash contributions of connections will remain part of the wholesale price control. This will encourage a more customer-focused approach and help support competition in the provision of connections.

The provision of developer information and administration for new connections is already a contestable activity (and has been for more than ten years). So it is not appropriate to set a default tariff for these activities.

The Water Bill sets out provisions for a new charging framework, whereby Ofwat will set charging rules for new connections. We will consult on these rules in due course.

It is companies' responsibility to set developer charges that comply with their existing duties (including competition law), and the future charging rules once they are in place.

In their business plans, some companies split out the retail costs associated with developer services, while others included the costs within those allocated to the default tariffs.

Companies will need to split out the retail costs of developer services, so that these are not recovered through the default tariffs. For the avoidance of doubt, the net margin (as described in chapter 5) will be included within the default tariffs, and will not be applied to the retail costs associated with services to developers. Charges to developers will need to be set separately to comply with companies' duties.

Table R4 has been amended to allow for explicit recognition of the retail service costs associated with services to developers, to minimise the risk of these costs being double-recovered through default tariffs as well as through charges to developers.

Our expectations:

1. For the retail service costs allocated to default tariffs to not include costs associated with services to developers.

4.4 Dual water and sewerage tariffs

In their business plans, some WaSCs proposed separate tariffs for customers that receive a dual service (that is, a separate 'dual' tariff, distinct from their water only and sewerage only tariffs). Others included a variable within their tariffs for customers that receive a dual or single service, while others simply had separate tariffs for water only retail services and sewerage only retail services with no explicit recognition of any economies of scope for where a customer receives both services.

We do not consider that having a separate dual service default tariff is the most effective approach for passing on to customers any economies of scope of providing both services. Under a dual service tariff, if a customer wished to change their retailer for one service, they would have to also change tariff for the other service.

It is debatable whether scope economies need to be explicitly recognised in default tariffs at all; as default tariffs are intended to provide a back-stop, with companies

being able to offer customers alternative tariffs if they wish to. Placing a de facto restriction on dual service discounts being offered as part of the default tariffs, however, would not likely be in customers' interests.

So, we consider that the most proportionate approach is for WaSCs to offer a tariff for water-only services, a separate tariff for sewerage-only services, and for where they considered that it would be appropriate to explicitly reflect economies of scope in the default tariffs (as opposed to through other means), to include a variable (that is, a discount) within the tariff. As a result, if a customer was to change retailer for one service, they would be able to remain on the default tariff for the other service, but would lose the dual service discount.

This issue was discussed at an industry workshop. One company queried whether requiring separate water-only and sewerage-only default tariffs would lead to incidence effects. We do not consider that this would be the case, as companies would still be able to propose the tariff structures, and would have the option of whether they chose to explicitly reflect any economies of scope.

We illustrate this in table 2 below, comparing one company that is not reflecting economies of scope through a tariff variable with one that is.

Table 2 Example of reflecting a dual service discount through a charging variable

	Company not using an economy of scope variable		Company using an economy of scope variable	
	Water only	Sewerage only	Water only	Sewerage only
Total revenue to recover	£3m	£4m	£3m	£4m
Fixed charge	£60.00	£66.67	£62.50	£68.75
Variable charge (economy of scope variable)	N/A	N/A	-£5.00	-£5.00
Fixed charge multiplier (number of customers)	50,000	60,000	50,000	60,000
Variable charge multiplier (number of customers on dual service tariff)	N/A	N/A	25,000	25,000

For the avoidance of doubt, all figures are illustrative – that is, a £5 discount may or may not be the appropriate level of discount to offer; companies would need to base their proposals on an assessment of their costs.

Also, to be clear, we are not opposed to the principle of dual service tariffs per se (and companies may choose to offer these to customers under the terms set out in section 2.1), but it is not appropriate for the default tariffs to be dual service.

Our expectations:

1. For WaSCs to offer a water only and wastewater only default tariff, and not a dual service tariff.
2. For WaSCs choosing to reflect economies of scope in the default tariffs, to use the approach outlined above of including a charging variable (as opposed to using a separate tariff to take account of the effect).

4.5 Special agreements

Total end user charges for special agreements for non-household customers should be reflected in table R4 in the same way as other charges for non-household customers are treated.

As with the other default tariffs, default tariffs for non-household special agreements must be compliant with competition law as well as companies' other existing duties and obligations. They should allow an 'efficient entrant' to enter the market for the provision of the special agreement.

Where retail costs differ significantly between different customers or customer groups on existing special agreement charges, it may be appropriate for water companies to include more than one default tariff to reflect such non-household special agreements.

Our expectations:

1. For companies to have considered whether separate default tariffs are required for any special agreements.

4.6 Net margin

A number of companies submitted R4 tables that did not include the net margin within the proposed charges. For the avoidance of doubt, **the charges in R4 should contain the net margin** – that is, lines 24 to 27 in the new R4 template.

Some companies had incorrectly applied the net margin. A margin is different from a mark-up[4]. The net margin is defined as retail earnings before interest and tax as a proportion of revenue. That is:

$$\text{Margin} = \left(\frac{\text{EBIT}}{\text{Revenue}}\right)$$

Or alternatively:

$$\text{Margin} = \left(\frac{\text{Revenue} - (\text{wholesale revenue} + \text{retail costs})}{\text{Revenue}}\right)$$

Consequently, total revenue can be calculated as:

$$\text{Total revenue} = \left(\frac{(\text{Wholesale revenue} + \text{retail costs})}{(1 - \text{net margin})}\right)$$

And retail service revenue can be derived from the above by deducting the wholesale revenue:

$$\text{Retail service revenue} = \left(\frac{(\text{Wholesale revenue} + \text{retail costs})}{(1 - \text{net margin})}\right) - \text{wholesale revenue}$$

(where the retail costs are opex, plus pension deficit repair costs, plus depreciation, excluding financing costs).

For example, where retail costs were £1 million, the wholesale revenue was £10 million, and the net margin was 2.5%, the retail service revenue would be:

$$\text{Retail service revenue} = \left(\frac{(10 + 1)}{(1 - 2.5\%)}\right) - 10 = £1.282 \text{ million}$$

[4] A mark-up involves multiplying a figure by 1 plus the mark-up.

In their business plans, companies put forward their views of proposed retail non-household net margins for default tariffs. There was a wide range of proposed non-household retail net margins, ranging from 0.02% to 37.45%.

On 27 January, we published 'Setting price controls for 2015-20 – risk and reward guidance' (our 'risk and reward guidance'). It included a proposed aggregate net margin for non-household retail of:

- 2.5% in England and for non-household customers using more than 50 Ml of water in Wales; and
- 1.0% for non-household customers in Wales using less than 50 Ml of water.

That is, that on aggregate over AMP6, we would expect the sum of all the default tariffs in total to have a net margin of 2.5% over expected wholesale charges and relevant retail costs, or 1.0% for customers using less than 50 Ml of water served by companies that are wholly or mainly operating in Wales.

In their business plans, many companies did not consider applying different margins to different tariff bands. While the risk and reward guidance set out our expectations for aggregate expected margins over AMP6 to be taken into account in setting price limits for 2015-20 summating all tariffs, it did not set any explicit expectations in relation to different margins for different proposed default tariffs.

We would expect companies to consider whether it would be appropriate to have different net margins for different tariff bands, as there may be different relevant financing costs and risks associated with different customer types.

In assessing companies' plans, we will consider the evidence that they submit justifying net margins on a per band basis, as well as bottom-up considerations of working capital requirements, and external benchmarks where appropriate.

In a report prepared for Ofwat, PwC considered the aggregate net margins of other sectors. While this analysis is not directly comparable to the net margins required for individual tariffs, it provides an assessment of the aggregate net margin for various different operations, and illustrates how margins can vary according to the type of customers and retail services being provided in competitive and regulated markets.

In any case, proposed net margins will need to more than cover the working capital associated with each tariff band, and companies should ensure that they do so. In assessing working capital requirements, companies may wish to cross-check their analyses against rates that new entrants are able to raise (that is, not vertically integrated water companies).

Many companies in their business plans did not consider having different margins for their proposed default tariffs in different years of the control period. We suggest that they should further consider whether a variation in margin for proposed default tariffs across different years would be appropriate given the expected retail non-household market environment in the next price control period.

For example, an argument could be made that for the first two years of AMP6 the risk of supplying non-household retail services will be broadly equivalent to those of household retail services as the retail market does not open until April 2017, and companies have important risk mitigants available in the non-household market (such as some more flexibility to vary price and service offers to meet customer requirements, and the ability to disconnect for non-payment). This would potentially imply the following profile of margin (in a case where retail costs and wholesale charges are forecast to be constant – that is, a simplistic case).

Table 3 Example of varying the net margin by year

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Net margin – England, and for customers using more than 50 Ml in Wales	1.0%	1.0%	3.5%	3.5%	3.5%	2.5%
Net margin – Wales	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%

For the avoidance of doubt, we are not proposing that companies should necessarily adopt the above profile, but that they should consider profiles that reflect the change in risk resulting from market opening.

Our expectations:

1. For companies to consider having different net margins for different proposed tariff bands.
2. Where companies have used different margins for different proposed tariff bands, for them to explain how they have determined the appropriate proposed margin.
3. For companies to have checked that the proposed net margins more than cover the working capital associated with each tariff band.
4. For companies to consider the profiling of the proposed net margin across the different years.
5. For companies to explain how they have decided to profile the proposed net margin.
6. For companies to consider Ofwat's risk and reward guidance (published in January 2014).

5. The treatment of costs

5.1 Cost allocation

The business plan submissions included a range of approaches to allocate costs between tariff bands. Not all the drivers used to allocate costs were particularly cost reflective.

On 24 March 2014, we published guidance relating to the cost allocation between household and non-household price controls. While allocating between tariff bands is a more granular activity, we consider that some minimum standards are also required.

In setting the below cost drivers described in table 4 below, we have generally stayed consistent with the cost drivers included in the household/non-household cost allocation guidance. However, we have set a slightly 'lower bar' to reflect the slightly different nature of the allocation exercise.

In their 27 June submissions, we require companies to allocate costs between bands using the below approaches as a 'minimum requirement'.

We encourage companies to use more cost-reflective allocation approaches (directly attributing costs wherever possible) than those set out below. For the avoidance of doubt, it is companies that will ultimately bear the consequences of the law should their cost allocations lead to breaches of competition law, and that complying with the below 'minimum requirements' will not in itself ensure that costs have been suitably allocated from a legal perspective.

However, it will not be acceptable for companies to allocate costs on a less cost-reflective basis than the drivers set out below. For example, allocating meter reading costs by customer numbers alone would not be acceptable.

Table 4 Minimum requirement cost drivers

Cost type	Cost driver
Billing	Number of bills raised
Contacts	Customer numbers
Debt management	Customer numbers
Doubtful debt	Directly attributable
Meter reading	Number of meter reads
Depreciation	Proportioned in line with billing and contact costs

In allocating costs between the different bands, companies will need to decide how to treat cost drivers where customers receive multiple services. For example, a single customer may receive water, sewerage, and trade effluent services – and so could be considered as one customer, three customers, or a derived number somewhere in between to reflect economies of scope (similar to the economies of scope adjustment used within the household retail controls). For allocating costs between the non-household tariff bands, it is for companies to decide how to treat the cost drivers based on their own specific cost functions.

Our expectations:

1. For companies to explain clearly the cost drivers they have used to allocate costs.
2. For companies to allocate costs using cost drivers that are at least as cost reflective as those identified above.

5.2 Cost reconciliation

Companies will need to ensure that costs reconcile to externally audited accounts for 2013-14, and reflect any updates made to their business plans as set out in our price control process.

Our expectations:

1. For costs to reconcile to externally audited accounts for 2013-14.
2. For data to reflect any updates made to companies' business plans as set out in our price control process.

6. Miscellaneous charges

As well as charges for core services (water, sewerage, and trade effluent), companies also levy a number of miscellaneous charges. These are often presented in companies' charges schemes, although they do not require Ofwat's approval in the same way as regulated charges.

Miscellaneous charges cover activities such as:

- stand pipe hire;
- disconnection;
- meter testing;
- provision of fire hydrants;
- pressure tests; and
- provision of unmetered supplies to cattle troughs.

Most of the costs associated with these charges are associated with the wholesale business. As such, they fall under either:

- the wholesale control; or
- have been explicitly excluded as set out in licence condition B.

However, there are some retail costs that are classed as 'miscellaneous' – such as supplying additional copies of bills. If costs associated with such activities were to be included in R4, then companies would potentially double-recover through the default tariffs as well as through the miscellaneous charges levied.

While this could be addressed by bringing the miscellaneous charges within the average revenue controls, we do not consider that this would be appropriate proportionate approach, as the charges have not required regulation to date, and bringing them within the average revenue controls would increase the amount of reporting requirements required to assess compliance with the controls.

As a result, the costs associated with such activities should be excluded from the costs used in R4, so that these are not recovered through the default tariffs. We have amended table R4 to allow for explicit recognition of these costs, to minimise the risk of them being double-recovered through default tariffs as well as through the miscellaneous charges levied. 'Costs associated with such activities' include any retail costs associated with carrying out miscellaneous wholesale activities.

Market codes covering the terms of the interactions between wholesalers and retailers in relation to miscellaneous charges will be further developed in conjunction with Open Water.

Our expectations:

1. For the retail service costs allocated to default tariffs to not include costs associated with miscellaneous charges.

7. Quality assurance

With the business plan submissions, there were a number of errors in companies' R4 tables, including:

- calculation errors;
- tariffs with zero charges;
- tariffs with zero customer numbers; and
- tariffs having a different number of charges than charging multipliers.

We have amended table R4, to include more built-in cross-checks to help reduce the amount of errors.

For the 27 June submission, we expect companies to apply appropriate checks to assure themselves of the quality of their submissions. We also expect them to supply a statement explaining how they have assured themselves that the revised information, tables and underlying data submitted are of high quality.

Data will need to reconcile to externally audited accounts for 2013-14 and will need to be subject to the same level of Board assurance as all other business plan tables submitted by companies following the risk-based review.

Our expectations:

1. For companies to apply appropriate quality checks to assure the quality of the submission.
2. For companies to produce a statement explaining how they have assured the quality of the submissions.

8. Completing the table

Line	Description	Guidance
Block A		
1	Total operating expenditure (excluding exceptional items)	Total non-household retail operating expenditure related to serving non-household customers, excluding exceptional items. For clarity, this line includes costs reported in 19 and 21. It excludes lines 2, 3, and 4. The cost of services purchased should be included, but the costs of services provided for third parties should be excluded. This should not include any expenditure funded by wholesale.
2	Total depreciation of assets included in RCV (assets existing before AMP6)	This depreciation charge is on tangible fixed assets, for non-household retail, that exist before AMP6. Depreciation should be reported on the same accounting basis as will be used for 2015-16 – ie, historical cost IFRS, FRS101 or FRS102. Note that this figure is not net of the amortisation of deferred credits and intangible assets.
3	Total depreciation of assets that are not included in RCV (AMP6 or later assets)	This depreciation charge is on tangible fixed assets, for non-household retail, that **do not** exist before AMP6. Depreciation should be reported on the same accounting basis as will be used for 2015-16 – ie, historical cost IFRS, FRS101 or FRS102. Note that this figure is not net of the amortisation of deferred credits and intangible assets.
4	Pension deficit repair costs	This is the pension deficit recovery cost for non-household retail, according to the shares set out in IN 13/17.

Line	Description	Guidance
5	Total non-household retail costs (opex plus pension deficit repair costs, plus depreciation, excluding financing costs)	Do not enter data here – this is a calculation that summates the first four rows. This shows the total non-household retail service costs.
6	Services to developers (retail)	This line is the retail costs associated with providing services to developers. The costs of connections sit within the wholesale control. This line reflects the costs of the provision of developer information and administration – ie, the retail component of developer services.
7	Miscellaneous costs	This line is the retail costs associated with the provision of 'miscellaneous services. The retail miscellaneous charges are relatively small. Therefore, if companies consider it appropriate to do so, they may choose to deduct a cost-reflective estimate, rather than conduct a detailed cost allocation exercise.
8	Total non-household retail costs less services to developers	Do not enter data here – this is a calculation that deducts lines 6 and 7 from line 5 to give the total retail costs to be allocated to the default tariffs.
9	Cross-check total non-household retail costs from tariffs	Do not enter data here – this summates the individual non-household retail costs from each of the tariff bands set out under block C. This should equal line 8. If it does not, then costs have not been allocated correctly across the proposed tariff bands.
10	Total non-household projected wholesale charge allocated to tariffs	Do not enter data here – this summates the individual projected wholesale charges from each of the tariff bands set out under block C.
11	Total non-household retail service revenue	Do not enter data here – this summates the individual non-household retail service revenue lines from each of the tariff bands set out under block C.

Line	Description	Guidance
12	Aggregate net margin	Do not enter data here – using lines 9, 10, and 11, this line calculates the total net margin across all tariff bands. We expect the AMP6 total to equal 2.5% for companies wholly or mainly operating in England, and to be between 1.0% and 2.5% for companies operating wholly or mainly in Wales.
Block B		
13	Demand-side water efficiency initiatives – gross retail expenditure	The retail operating costs of providing water efficiency services to non-household customers, including: • promoting water saving initiatives – producing customer literature and customer awareness campaigns; • retrofitting water saving devices – providing advice and devices to customers; • water efficiency audits – water and energy conservation, optimisation of systems, advice and investigations into usage; and • data logging.

Line	Description	Guidance
14	Demand-side water efficiency initiatives – funded by wholesale	The retail operating costs of providing water efficiency services to non-household customers that are funded by the wholesale business and hence reflected within the wholesale charges to the non-household retail business, including: • promoting water saving initiatives – producing customer literature and customer awareness campaigns; • retrofitting water saving devices – providing advice and devices to customers • water efficiency audits – water and energy conservation, optimisation of systems, advice and investigations into usage; and • data logging.
15	Demand-side water efficiency initiatives – net retail expenditure	The retail operating costs of providing water efficiency services to non-household customers, net of any operating costs that are funded by the wholesale business and recovered from the retail business through wholesale charges, including: • promoting water saving initiatives – producing customer literature and customer awareness campaigns; • retrofitting of water saving devices – providing advice and devices to customers; • water efficiency audits – water and energy conservation, optimisation of systems, advice and investigations into usage; and • data logging.

Line	Description	Guidance
16	Customer-side leak repairs – gross retail expenditure	The retail operating costs associated with non-household customer side leaks, including: • investigations – activities from enquiries relating to customer-side leaks, including site visits, the use of pipe locating equipment and any attendance on sites during excavations; • resolution – activities comprising pipe repairs and replacement; and • free leak repairs.
17	Customer-side leak repairs – funded by wholesale	The retail operating costs associated with non-household customer side leaks that are funded by the wholesale business and hence reflected within the wholesale charges to the non-household retail business, including: • investigations – activities from enquiries relating to customer-side leaks, including site visits, the use of pipe locating equipment and any attendance on sites during excavations; • resolution – activities comprising pipe repairs and replacement; and • free leak repairs.

Line	Description	Guidance
18	Customer-side leak repairs – net retail expenditure	The retail operating costs associated with non-household customer side leaks net of any operating costs that are funded by the wholesale business and recovered from the retail business via wholesale charges, including: • investigations – activities from enquiries relating to customer-side leaks, including site visits, the use of pipe locating equipment and any attendance on sites during excavations; • resolution – activities comprising pipe repairs and replacement; and • free leak repairs.
19	Total demand-side water efficiency and customer-side leak repairs not funded by wholesale (and so funded through retail service charges)	The total retail operating costs of providing water efficiency services to non-household customers plus the total retail operating costs associated with non-household customer-side leaks.
Block C		
20	[Tariff name] [volume band] [water/sewerage] [metered/unmetered]	Enter the name of the individual tariff band and service.
21	Total retail costs for this tariff band (opex including pension deficit repair costs, plus depreciation, excluding financing costs)	Total retail costs for this tariff band (opex including pension deficit repair costs, plus depreciation, excluding financing costs).

Line	Description	Guidance
22	Customer numbers on this tariff band	The number of customers for this tariff band. Companies should assume in populating R4 that there are no customer losses due to competition (ie, there is zero churn). Customer numbers are defined as the average number of properties connected over the year, excluding void properties.
23	Net margin	As a percentage, please enter, for each year, the net margin for this tariff band. Note that this figure was previously provided in R5.
24	Tariff band – fixed charge element	The proposed amount that the company will charge customers for the retail service on a fixed basis (£).
25	Tariff band – variable charge element	The proposed amount that the company will charge customers using additional tariff components. These may be additional volumetric rates, if stepped charges are used, or other specified charges (£). A description of the charge should be included.
26	Tariff band – [description of additional retail charge 1]	
27	Tariff band – [description of additional retail charge 2]	
28	Charge multiplier – fixed charge element	The aggregate basis for charging customers for each of the associated charges. For example, if the basis for the associated charge is to charge per customer, then the multiplier would be the total number of customers charged on this tariff. The multipliers should use the required unit so that when multiplied by the charge (in £s), the product is in £m. While companies may present tariffs outside of the table using different orders of magnitude (such as litres rather than megalitres), the unit that gives line 30 in £m should be used for block C.
29	Charge multiplier – variable charge element	
30	Charge multiplier – [description of additional retail charge 1]	
31	Charge multiplier – [description of additional retail charge 2]	

Line	Description	Guidance
32	Total non-household retail service revenue	Do not enter data here – this calculates the total non-household retail service revenue for this tariff band by multiplying the above fixed and variable components by the multipliers provided.
33	Cross-check non-household service revenue	Do not enter data here – this calculates the total non-household retail service revenue for this tariff band by applying the margin provided to the projected wholesale charge and retail costs (line 22 to lines 20 and 33), and then compares with row 32.
34	Projected wholesale charge for this tariff band	The projected wholesale charge, in £m, expected for customers of this tariff band. As we explained in our methodology statement, the actual wholesale charges will not be constrained by default tariffs but instead by the total allowed wholesale revenues set in a company's price limits and other relevant licence conditions and legal requirements (including compliance with Ofwat's charging rules as applicable under the proposed framework in the Water Bill, and competition law).
35	Debtor days for this tariff band	The average debtor days expected for customers on this tariff band. This will be used to cross-check working capital requirements – if companies cannot break this down by customer group, they should use the average across all customers. Alternatively, if companies do break this down they should explain why this is different for each default tariff.
36	Average gross margin per customer	Do not enter data here – this line provides a calculation for the average gross margin per customer within the given tariff band. Companies may wish to use this line to sense check their proposals.

Line	Description	Guidance
37	Average gross margin	Do not enter data here – this line provides a calculation for the average gross margin for the given tariff band. Companies may wish to use this line to sense check their proposals.

9. Consolidated list of expectations

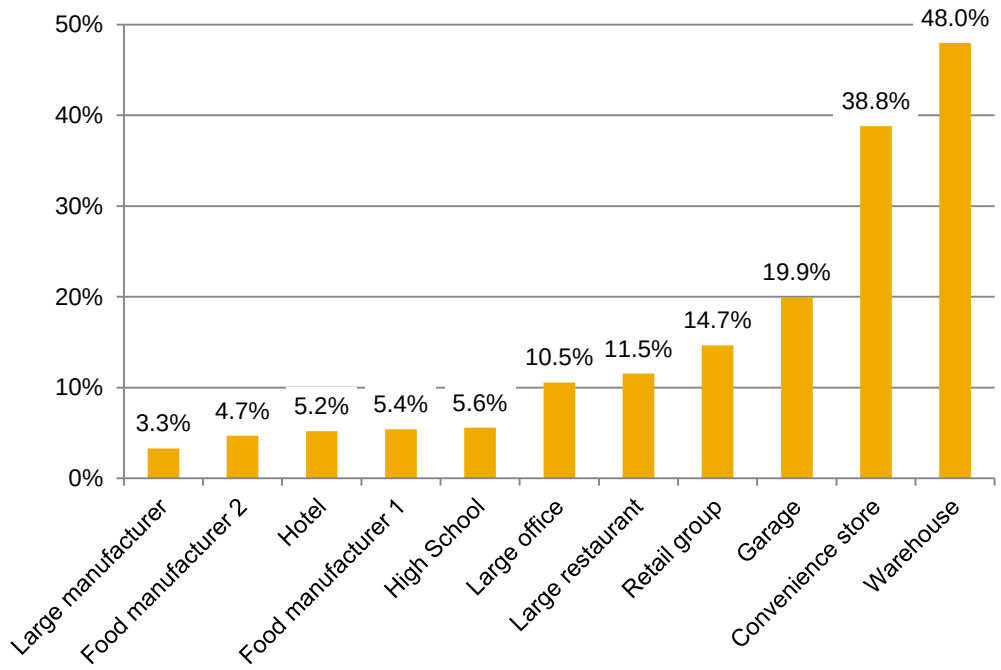
1. If assumed wholesale charging structures differ from existing tariff structures, for a clear justification to be provided why an alternative structure has been used to calculate the projected wholesale charge.
2. For companies to consider re-balancing the wholesale charges across the non-household tariff bands to limit the implication of any significant incidence effects.
3. If new structures are proposed, for companies to explain clearly why they consider those structures to be appropriate.
4. If new structures are proposed, for companies to have considered the potential incidence effects.
5. For companies to have included distinct proposals for the services identified above in completing table R4.
6. For companies to explain why they have decided on the number of tariffs proposed.
7. For the retail service costs allocated to default tariffs to not include costs associated with services to developers.
8. For WaSCs to offer a water only and wastewater only default tariff, and not a dual service tariff.
9. For WaSCs choosing to reflect economies of scope in the default tariffs, to use the approach outlined above of including a charging variable (as opposed to using a separate tariff to take account of the effect).
10. For companies to have considered whether separate default tariffs are required for any special agreements.
11. For companies to consider having different net margins for different proposed tariff bands.
12. Where companies have used different margins for different proposed tariff bands, for them to explain how they have determined the appropriate proposed margin.
13. For companies to have checked that the proposed net margins more than cover the working capital associated with each tariff band.
14. For companies to consider the profiling of the proposed net margin across the different years.
15. For companies to explain how they have decided to profile the proposed net margin.
16. For companies to consider Ofwat's risk and reward guidance (published in January 2014).
17. For companies to explain clearly the cost drivers they have used to allocate costs.
18. For companies to allocate costs using cost drivers that are at least as cost reflective as those identified above.

19. For costs to reconcile to externally audited accounts for 2013-14.
20. For data to reflect any updates made to companies' business plans as set out in our price control process.
21. For the retail service costs allocated to default tariffs to not include costs associated with miscellaneous charges.
22. For companies to apply appropriate quality checks to assure the quality of the submission.
23. For companies to produce a statement explaining how they have assured the quality of the submissions.

Appendix 1: Examples of gross margins by customer type

In Scotland, default tariffs for non-household customers have been in place since 2008. Figure 4 below shows the gross margins from 2008-09 for a number of 'standard customers'[5].

Figure 4 Gross margins for standard customers in Scotland from 2008-09



There are a number of reasons why the gross margins set out above may be different for companies in England and Wales, such as:

- different payment terms; and
- different wholesale revenue requirements.

But they provide a useful comparator, and it is informative to note the degree that gross margins vary by different types of customer.

[5] Standard customers are further defined in 'The Strategic Review of Charges 2006-10'.

Appendix 2: Different average revenue controls

The possibility of having a single average revenue control for each service has been suggested previously. Where there is significant variability in the costs of serving customers, this is not appropriate as different customer types may require different net margins and different retail costs to serve.

For example, if the three average revenue controls in section 2.2 were combined into a single control, while the forecast allowed revenue would remain the same, if a company were to lose a customer whose costs significantly differed from the average, that company would subsequently recover (in aggregate) a non-cost reflective amount. We illustrate this numerically in table 4 below.

Table 5 Example of an aggregated average revenue control

	A	B	C	Total	Notes
Retail costs (per customer)	£30	£50	£80	£38	Total calculated by weighting by customer numbers
Wholesale revenue	£15m	£25m	£20m	£60m	Total calculated by summating A, B, and C
Net margin	1.50%	2.50%	3.50%	2.50%	See chapter 5
Customer numbers	200,000	100,000	10,000	310,000	Total calculated by summating A, B, and C
Total revenue	£21.32m	£30.77m	£21.55m	£73.64m	Using the formula set out in section 2.2
Retail service revenue	£6.32m	£5.77m	£1.55m	£13.64m	Total revenue minus the wholesale revenue

As the table illustrates, the retail service revenue is £13.64 million regardless of whether the individual bands are summated, or whether the revenue is calculated using the aggregate data in the rows above. However, because the retail costs have been averaged (row 1), should the company lose a high-cost (tariff C) customer, for the next charging year the company would only lose £38 plus 2.5% net margin from its revenue control, rather than £80 plus 3.5% net margin – that is, the company would subsequently over-recover from its remaining customers.

Alternatively, if the company lost a low-cost customer (tariff A), it would subsequently under-recover because of the revenue allowance reducing to a greater extent than the associated costs.

Also, setting a single revenue control could generally give companies greater opportunity to over/under-charge different types of customers.

As a result, companies need to propose different tariff bands to sufficiently reflect the relative cost characteristics of their customers.

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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