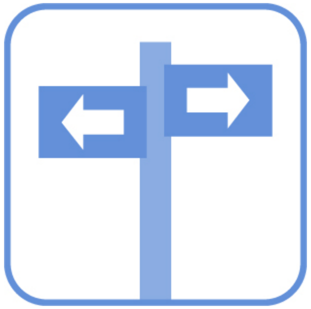
Retail workshop

17 April 2014

Agenda



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2	Retail cost allocation	2.10 pm
3	ACTS adjustments	2.40 pm
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About this workshop

Following the announcement of the risk-based review results, we are holding a series of workshops across the elements of the business plan

The purpose of these sessions is to provide companies with the opportunity to raise questions with the Ofwat team. We are doing this in a workshop format to allow us, and companies, to use time effectively and efficiently

Our objective is to support companies to understand our approach and our requirements. We want to help companies to improve aspects of their plans, to address any gaps identified during the risk-based review, and to continue to take ownership and accountability of their plans

The workshop materials will be put on our website, along with the main points/questions and answers, without attribution. There will be no detailed meeting note

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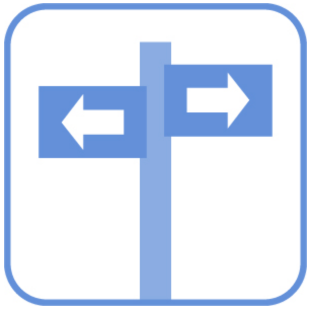

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Retail cost allocation – background

A robust and consistent allocation of costs across the retail/wholesale and household/non-household boundaries is important because:

1. There needs to be a level playing field for companies and customers when the retail market opens for non-household customers in England in April 2017

2. Regulatory tools, such as the ACTS, are comparative – consistent allocation of costs is needed to ensure that regulatory incentives apply fairly across companies

To ensure a robust and consistent approach to cost allocation for the 2014 price review (PR14) we included a test on this as part of our risk-based review

Retail cost allocation – proposed cost drivers

On 24 March we issued more detailed cost allocation rules that companies must apply for PR14

Where possible costs should be directly attributed between wholesale/retail and between household/non-household

The cost drivers set out in this document should only be used to allocate costs where direct attribution is not possible

Where companies are unable to follow our new guidance in full, they should:

Explain why they are unable to follow our guidance
Take a sampling approach extrapolating the results
Explain the approach taken to sampling
Obtain external assurance on the adequacy and representiveness of their sample
Inform us how and when they expect to be able to comply with our new guidance in full

Retail cost allocation – next steps (1)

Existing business plan information (tables R3, A19 and supporting information) should be updated in line with the new rules:

Enhanced companies by 11 April or 27 June
Companies seeking a June draft determination by 2 May or 27 June
Companies seeking an August draft determination by 27 June

Companies should also submit commentary explaining:

Changes from December business plan submissions
Any change in wholesale costs (pre-qualified companies)
Revised wholesale business planning tables (other companies)
Variance between updated costs and those in their 2013-14 regulatory accounts

And external assurance reports

Retail cost allocation – next steps (2)

These changes **do not affect the regulatory accounts for 2013-14 or 2014-15** which should be prepared under existing RAGs and information notices (notably IN 14/05). We will be consulting on changes to the RAGS for 2015-15 in the autumn

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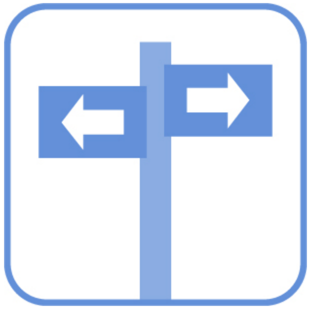

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ACTS adjustments – background

As we explained in our July methodology statement, companies could propose adjustments to the company's cost to serve for factors that:

1. Have a material impact on their costs
2. Are beyond efficient management control (having taken all possible steps to control it)
3. Impact the company in a materially different way to other companies

In the risk-based review we also considered new costs where:

1. Forecast costs are materially higher than 2013-14 costs, taking account of changes in the number of customers
2. Forecast costs relate to retail investments for which funding was requested in the AMP5 price control

We have assessed whether the company has provided sufficient and convincing evidence to justify these new costs

ACTS adjustments – risk-based review results

Company	Bad debt	Input price pressure	Thames Tideway	Economies of scope	New costs	Overall
ANH	N/A	N/A	N/A	N/A	N/A	B
WSH	D	C	N/A	N/A	N/A	D
NES	D	C	N/A	N/A	D	D
SVT	N/A	D	N/A	N/A	N/A	D
SWT	C	N/A	N/A	N/A	N/A	C
SRN	C	C	N/A	N/A	N/A	C
TMS	N/A	N/A	D	N/A	C	D
UU	C	N/A	N/A	N/A	C	C
WSX	N/A	N/A	N/A	C	D	D
YKY	N/A	C	N/A	N/A	N/A	C
AFW	N/A	N/A	N/A	N/A	N/A	B
BRL	N/A	C	N/A	N/A	N/A	C
DVW	N/A	C	N/A	N/A	C	C
PRT	N/A	C	N/A	N/A	N/A	C
SBW	N/A	C	N/A	N/A	N/A	C
SEW	N/A	C	N/A	N/A	N/A	C
SSC	C	C	N/A	N/A	N/A	C
SES	N/A	C	N/A	N/A	N/A	C

ACTS adjustments – materiality

Materiality

We compare adjustment expenditure for all of AMP6 to 2.25% of total AMP6 household retail expenditure (depreciation + opex)

This threshold is equivalent in absolute terms at the appointee level to the thresholds for wholesale

We use the same threshold for adjustments and new costs

We have normalised the change in opex and depreciation for changes in customer numbers and meter penetration to assess whether new costs are material

Immateriality

Immaterial adjustment claims fail the first criteria (slide 9) and so no adjustment will be made

A modification to the base year CTS will be made for immaterial new costs without further assessment

ACTS adjustments – input price pressure

Risk-based review results

12 companies sought an adjustment to ACTS for input cost pressure within their retail businesses

No company provided us with sufficient evidence to demonstrate they were efficient at managing input price pressure compared to companies beyond the water sector

What further evidence is needed?

Qualitative or quantitative benchmarking of the company's input price pressure management practices against other industries beyond the water sector

Evidence that the company is cost efficient across all the main cost domains (for example, labour, IT, debt) as compared with a cross-sectoral industry benchmarks both within and beyond the water sector

ACTS adjustments – doubtful debts

Risk-based review results

Six companies requested an adjustment for doubtful debts

Following the pre-qualification decision, and after submission of additional evidence by SWT, we have agreed to make an adjustment to SWT's cost to serve due to the impact of deprivation and bill size on its level of doubtful debt

We do not think that evidence that is lacking econometric support is likely to explain sufficiently the nature of the relationship between doubtful debt and its drivers (including deprivation) and so would not be considered for an adjustment

What further evidence is needed?

Use of more sophisticated econometric regression analysis/models. But SWT's model may not be appropriate for all companies

Evidence that debt management practices are efficient

ACTS adjustments – new costs

Risk-based review results

Three companies had material new costs, and two had asked for new costs for billing system investments in AMP6 when they had included these in their AMP5 plans as well

Evidence to support these costs was generally limited

What further evidence is needed?

Justifying why the costs need to be incurred in this AMP

Whether the proposed solution was the most cost beneficial, including assessment of alternative options

How the quantum of the costs had been arrived at and why this was produced an efficient estimate

Linking these investments back to customer needs

ACTS adjustments – next steps

Companies can provide updated evidence to support their adjustments

This should focus in particular on:

1. Providing evidence that the company is doing as much as possible to efficiently manage these costs. This should include benchmarking cost management practices across and outside of the water and sewerage industry
2. Evidence that the size of the adjustment (and the costs included in the cost to serve) are appropriate

For new costs, companies should provide evidence that:

1. There is a need for the new costs
2. The new costs are the most efficient way of meeting that need
3. The quantum of the new costs have been justified
4. The costs protect customers

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Default tariffs – background

There were a number of issues with the default tariffs proposed by companies in their plans

Due to widespread nature of the issues, we decided to remove default tariffs from the risk-based review and adopt an adapted process

All companies → Submit revised R4 tables along with a supporting narrative explaining their approaches

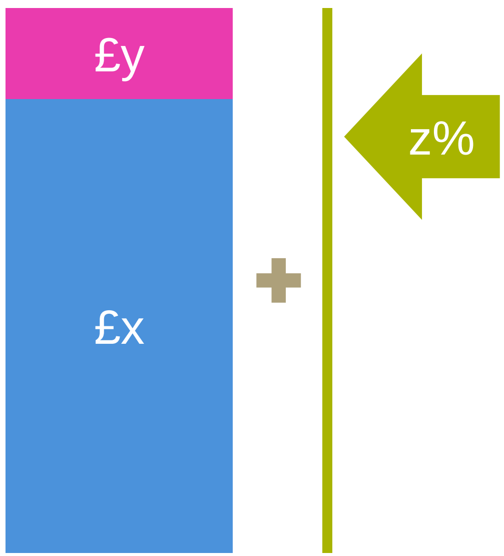
27 June 2014

Ofwat → Draft determinations for all companies to be set

29 August 2014

Default tariffs – what will Ofwat set?

We will set draft non-household retail revenue controls on **29 August** for **all companies**



- Retail net margin
- Retail cost
- Wholesale input price

Net margin is set as a % of total revenue

For example, net margin = 2.5%
Total bill for an example customer =
£90.00 wholesale revenue
+ £7.50 retail average cost
+ £2.50 net margin

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 set as an average cost per customer by customer type:
£y average revenue per customer

Plus a net margin:
+ z% net margin: % of total customer bill

Default tariffs – net margin variation

Companies can propose to vary net margins within the period for different customer bands

However, in each year the margins for different customer must still aggregate to 2.5% at the company level

This allows companies to propose to increase the relative net margin for those customer bands for which the introduction of competition increases the risk for retailers

	2015-16	2016-17	2017-18	2018-19	2019-20	Average
Band 1 net margin	1.0%	1.0%	3.5%	3.5%	3.5%	2.5%
Total band 1 revenue (£ million)	5	5	5	5	5	
Band 2 net margin	3.25%	3.25%	2.0%	2.0%	2.0%	2.5%
Total band 2 revenue (£ million)	10	10	10	10	10	
Weighted average net margin (weighted by band revenue)	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%

Key issue: how should dual service tariffs be portrayed?

We consider that the most proportionate approach is for WaSCs to propose:

1. A tariff for water-only services

2. A separate tariff for sewerage-only services

3. 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

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. We will not require companies to offer the charges proposed in R4

Default tariffs – tariff proposals example

	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

Default tariffs – cost allocation

Costs must be allocated between different customer bands in a way that is at least as good as that set out below

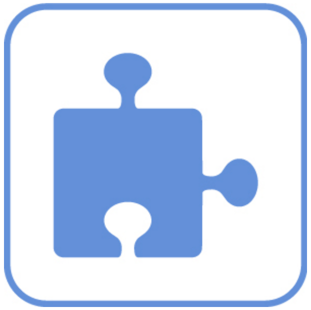
'Better than' would be using a more cost reflective cost driver to allocate costs

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

Expectations:

1. **Companies to explain clearly the cost drivers used to allocate costs**
2. **Companies to allocate costs using cost drivers that are at least as cost reflective as those identified above**

Default tariffs – miscellaneous charges



Miscellaneous charges are mostly associated with the wholesale business (for example, items like stand pipe hire and pressure tests)

Those that are associated with retail (for example, additional copies of bills) could be double-recovered through default tariffs and miscellaneous charges levied if they are included in default tariffs (in R4)

It is not appropriate to bring miscellaneous charges within the average revenue controls (due to adverse impacts on regulatory burden). The proportionate solution is to exclude the charges from default tariffs

Expectation: retail service costs allocated to default tariffs not to include costs associated with miscellaneous charges

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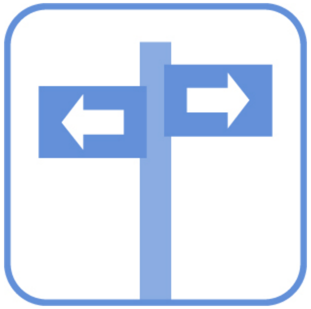

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Questions

Has anything changed in the way that water efficiency and supply pipe leak repair costs should be allocated?

How should capex/depreciation be allocated?

Are companies to use current service levels which correspond to current costs?

Are there any specific assumptions which companies should be using? (for example, common debtor days)

Are negative/zero wholesale charges to be allowed?

How are you treating new costs in non-household retail?

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Next steps

As noted earlier, the workshop materials will be put on our website, along with the main points/questions and answers, without attribution. There will be no detailed meeting note

Please continue to liaise with your portfolio lead if there are further queries after today

Thank you for attending

Questions and answers on retail

Cost allocation

Q1. Can you clarify how companies should allocate the costs of demand-side water efficiency, customer supply pipe leak repairs and network calls in their revised tables?

Demand side water efficiency and customer supply pipe leak repair
We have not changed the way that demand-side water efficiency and supply pipe leak repair costs should be allocated from what was required in the December business plan submissions.

Water efficiency and supply pipe leak repair costs should be allocated wholly to retail. As we had previously set out, where these activities are driven by supply/demand balancing needs, and so should be funded through wholesale, the amount that is funded by wholesale (but carried out by retail) should be made clear (in block B of R3 and R4).

Network customer enquiries and complaints (that is, receiving and passing on a phone call, email, letter, etc.)
This is defined in the 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; and**
> - **internally generated calls to the retail call centre to enable the customer call to be resolved."**

The guidance on page 7 of '2014 price review cost allocation for retail and wholesale price controls' (our 'guidance on cost allocation'), which we published in March 2014, states that network customer enquiries and complaints should be allocated wholly to retail. This is the case regardless of whether a site visit happens, and the outcome of that visit.

When undertaking an investigation (that is, a site visit) on account of a network customer enquiry or complaint, the investigation should be included in wholesale if the cause of the network customer enquiry or complaint was a network issue. The initial investigation costs should be included in retail where the visit is driven by a customer call and is found not to be as a result of a network issue. If there are multiple causes for the investigation that relate to wholesale network issues or retail issues then companies are welcome to use a sensible approach to apportion costs and we are not prescribing a particular cost driver. This was clarified in the slides from the retail price control workshop on 26 September 2013 (slide 9). This does not affect the allocation of the network customer enquiry and complaint cost (1 above).

Q2. How should capex/depreciation be allocated?

Where an asset is used both by wholesale and retail, then, for simplicity, the principal use rule should apply. In most cases we would expect that wholesale would be the principal user, and so the capex and depreciation costs should be recorded in wholesale with a recharge being made to retail. The recharge should reflect the proportion of the asset used by retail. The recharge to retail should be recorded in line 1 of R3 and line 1 of R4. The corresponding entry (income in wholesale) should be netted off against wholesale operating expenditure in line 36 of table W3 and line 59 of S3.

We will need you to tell us the total amount of recharges relating to legacy assets that you have included in operating expenditure in line 1 of table R3. We will need to ensure that this amount is not included in the calculation of the average cost to serve (ACTS).

Where an asset is used solely within wholesale but used by both water and wastewater, then the capex and depreciation costs should be apportioned between water and wastewater using an appropriate cost driver.

Likewise, where an asset is used solely within retail but used by both household and non-household, then costs should be apportioned between household and non-household using an appropriate cost driver.

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

Q3. Are there any specific assumptions which companies should be using (for example, common debtor days)?

In line with information notice 'IN13/21: Payment terms between wholesalers and retailers', the assumptions on payment terms that should be common for all companies are as follows.

Decisions at a glance	
Setting of payment terms	Wholesalers must offer standard terms to everyone. Non-standard terms can be used where a wholesaler and retailer agree with each other to do so. Wholesalers must publish any non-standard terms they agree and make these terms available to all retailers.
Scope of products and services	Payment terms apply to all products and services provided between wholesalers and retailers. Services provided directly by the wholesaler to end customers are not covered by these payment terms.
Settlement period	One calendar day
Details of payment terms	
Billing period	**Standard term**: One calendar month
Payment period	**Standard term:** 30 days from the last day of the billing period, or 15 days after the invoice is deemed to be received, whichever is the later.
Credit requirement	**Standard term:** a retailer needs to have either: • a letter of credit from a guarantor with a minimum credit rating that will be set out in the market documents; or • an agreement with a wholesaler to use an escrow account. **Additional safeguard for deviation from standard term:** a wholesaler needs to: • offer proportionate credit and collateral arrangements; and • explain clearly the rationale for credit decisions.

Q4. Should we be treating disconnection costs for both 'capping off' (customers leaving a site) and debt collection related disconnections in the same way?

As set out in the business planning guidance and in our guidance on cost allocation, the physical activity of disconnections and reconnections should be allocated to wholesale and the decision and administration of disconnections and reconnections to retail.

For default tariffs, if a company levies a charge for disconnection, then costs associated with this activity should be treated as a 'miscellaneous cost' item to avoid double recovery through the default tariffs and miscellaneous charges levied. If no charge is levied, then the company should allocate the costs between tariff bands in a cost reflective manner.

Q5. Should cost reallocations for previous years be restated to follow the new guidance?

Yes, cost allocations for previous years (2010-11 to 2012-13) should be restated to follow the new guidance.

Q6. Are companies expected to re-submit their cost allocation tables on the basis of finalised 2013-14 figures?

Companies should re-submit business plan tables R3 and A19 by 2 May or 27 June and R4 by 27 June based on the most up to date information that companies have available to them. This should be the 2013-14 actual figures but we note that in a number of areas there are slightly different definitions for business plan purposes to those for the regulatory accounts purposes. This means that there is a need to provide a reconciliation between business plan submissions and the regulatory accounts with supporting commentary.

Companies must also resubmit the detailed tables that we requested in our 6 January query. Companies should ensure that they complete these tables at a sufficiently detailed level to enable us to see that they have allocated all of the costs mentioned in the 24 March guidance in line with this guidance and that they have addressed the issues that we identified as part of the risk based review.

Companies will also need to resubmit any revised wholesale business planning tables with some commentary explaining the change in costs from those submitted in December business plans.

Default tariffs

Q7. How are customer types/customer bands defined for default tariffs?

For each customer type there will be one default tariff.

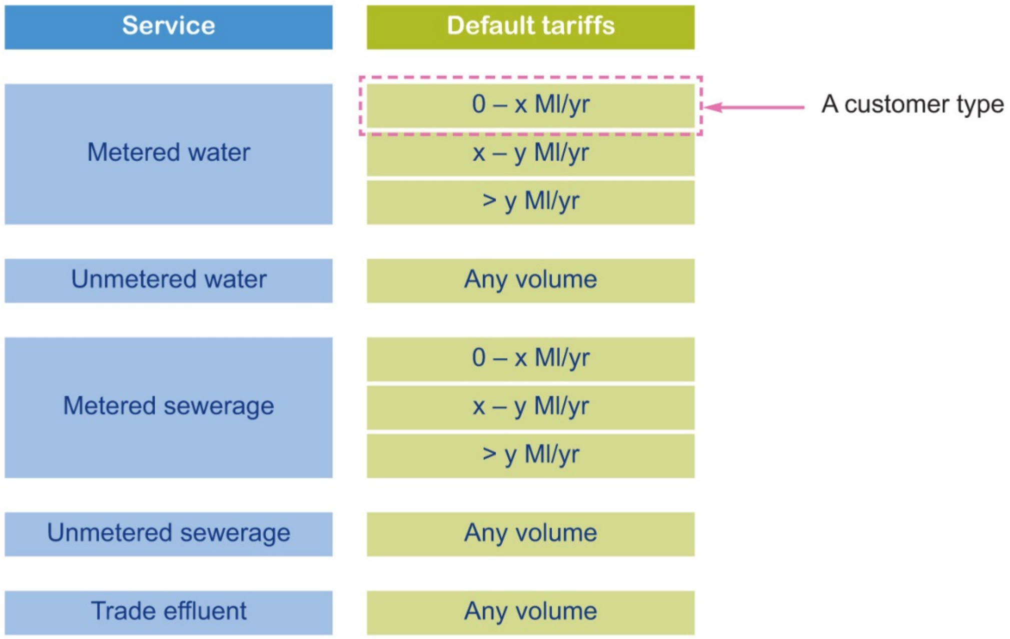
Customer type can be defined by the following.

- The service the customer receives (metered water, unmetered water, etc.).
- The volume of water/sewerage that the customer consumes/produces.

If a company thinks that there are additional characteristics that sub-divide its customer base further, then a customer type could be defined at a more granular level. For example, if a company has metered water only customers within a range of usages (say >50 Ml/yr), some of whom have seasonal tariffs and some of whom do not, then customer type could be further disaggregated into the following customer types:

- seasonal metered water >50 Ml/yr; and
- non-seasonal metered water >50 Ml/yr.

The illustration below provides an example of how customer types may be defined for an example WaSC. Note that the symbols 'x' and 'y' have been used in place of numbers as we do not want to give the impression that Ofwat knows what the correct boundaries (or number of boundaries) are for any companies; this is for companies to decide.



Note that at a minimum each company should have at least one customer type for each of the services defined on pages 11 and 12 of 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs'.

Q8. Can you explain exactly what is being set as the default tariff controls?

This is explained on slide 18, with further clarification given here.

For each customer type, as proposed by companies according to the definition above, we will set a default tariff price control which consists of two components:

1. a £ per customer average cost allowance; and
2. a % net margin.

We will set these two numbers for each default tariff for each year of AMP 6. For example, a default tariff could be set in the following way.

Average revenue control for default tariff for metered water customers (0 – 1 Ml/yr)	2015-16	2016-17	2017-18	2018-19	2019-20
Average cost allowance (£/customer)	40	40	40	40	40
Net margin (%)	2.0	2.0	2.5	2.5	2.5

As we are setting these as an average revenue control, the average revenue that can be collected from any customer on a particular default tariff in a particular year is given by the formula below. Note this includes the wholesale and retail components of the revenue that can be collected.

allowed average revenue per customer

$$= \left(\frac{\text{(no. of customers on default tariff} \times \text{average cost allowance (£ per cust))} + \text{wholesale revenue for default tariff (£ million)}}{\text{(1} - \text{net margin (\%))}} \right) \Big/ \text{no. of customers on default tariff}$$

This is equivalent to the total revenue for a default tariff as set out on page 11 of 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs' divided by the number of customers on the tariff.

Q9. How is the default tariff net margin allowed to vary over time?

The net margin for each default tariff for a given customer type can vary between years. Where a net margin does vary between years, an explanation of why this is the case must be given.

The company level net margin is the non-household retail net margin as a proportion of total non-household revenue.

company level net margin (%)

$$= \frac{\text{total non-household net margin (£ million)}}{\text{(total non-household retail costs (£ million)} + \text{total non-household net margin (£ million)} + \text{total non-household wholesale revenue (£ million))}}$$

Note that this results in the same net margin figure as the weighted average net margin calculation described on slide 19. The company level net margin for the non-household retail business must not exceed 2.5% in any year for companies operating wholly or mainly in England. Because of this, the average company level net margin across the five years must not exceed 2.5% either.

The company level net margin may be less than 2.5% in any year. But, where this is the case, this must not produce a margin squeeze – it is for the company to demonstrate that a lower net margin in any year will not result in a margin.

At the individual default tariff level, the net margin may vary between years and between individual default tariffs so long as the company level net margin does not exceed 2.5% in any given year.

For companies operating wholly or mainly in Wales, the limit on net margin is set at 1% for all wastewater customers and water customers using less than 50 Ml/yr. For these companies, the weighted average net margin across default tariffs for customer types with a 1% net margin limit must not exceed 1% in any given year. Similarly, the weighted average net margin across default tariffs for customer types with a 2.5% net margin limit must not exceed 2.5% in any given year.

Q10. In the new R4 table the checks and balances, the default tariff revenues are compared to expenditure including depreciation on the pre-2015 retail asset base. Is this correct?

Yes, this is correct.

Depreciation of pre-2015 assets is funded through the wholesale controls for household retail. Because of this, the depreciation of these assets is not funded in the household retail control, so that these assets are not funded for twice.

For non-household controls however, the depreciation of pre-2015 retail assets in the retail control will be funded through the non-household retail control (that is, the default tariffs). This is because not including funding for these assets within the non-household retail control could potentially cause a margin squeeze for new entrants, as new entrants will have to bear the full costs of any assets that they require.

The checks included in the new R4 table are therefore correct and different to the household retail price control.

Q11. Should companies use current service levels which correspond to current costs when setting default tariffs?

As we have previously stated (for example, in 'Consultation on retail controls for the 2014 price review'), part of what we are trying to achieve with default tariffs is to minimise incidents effects for customers. This is true for both price and service levels.

Companies must offer at a minimum the GSS level of service to all customers. However, we would expect companies to continue to offer their existing level of service to customers on default tariffs. (This is what Ofwat previously referred to as 'rolling over' tariffs.) The default tariffs should therefore be based on existing service levels, and the costs by tariff band should be based on existing costs.

Q12. Are negative/zero wholesale charges to be allowed?

In the default tariff setting process we are not setting charges – neither for retail nor wholesale. As such this question is not a question for default tariffs.

From a charging perspective, a wholesale charge that was zero or negative would unlikely be cost reflective and so would not be allowed.

From a default tariff perspective, a default tariff with a zero or negative wholesale charge would imply that there is a retail service being provided to a customer for whom there is no associated wholesale service being provided. It would need to be explained why a default tariff would be needed in this non-household.

Q13. How are new costs to be treated in non-household retail?

We are treating new costs in the same way as for household retail. That is, we will assess material new costs as to whether evidence has been provided for:

- the need for the cost (for example, evidence of need for new investment, willingness to pay analysis, extent of stakeholder support, any independent evidence);
- if it is the most cost beneficial solution (for example, options appraisal, cost-benefit analysis, value for money analysis);
- robustness of estimate (for example, robustness of company's approach to justifying expenditure, comparison with AMP5, use/quality of benchmarking); and
- if consumers are protected (can the benefits from this expenditure be verified – for example, any link to outcomes, other evidence?).

If the new cost is justified, we will make a modification to the default tariff to account for the new costs.