August 2014

Setting price controls for 2015-20

Draft price control determination notice: technical appendix A4 – household retail

Contents

Overview

This document sets out our approach to setting the draft determinations for household retail price controls for the five years from 1 April 2015 and summarises the results of our review of companies' business plans.

The 2014 price review sets the first separate price controls for customer facing 'retail' services for households. The household retail costs included in companies' business plans for 2015 to 2020 are £4.1 billion. These retail controls ensure customers have an appropriate level of protection on service and price. By setting separate controls for household customers and non-household customers we have distinguished between customers without and with a choice of supplier.

Overall our challenges to companies' retail costs will save customers £0.9 billion between 2015 and 2020[1]. The key results of our review of the companies' business plans are as follows:

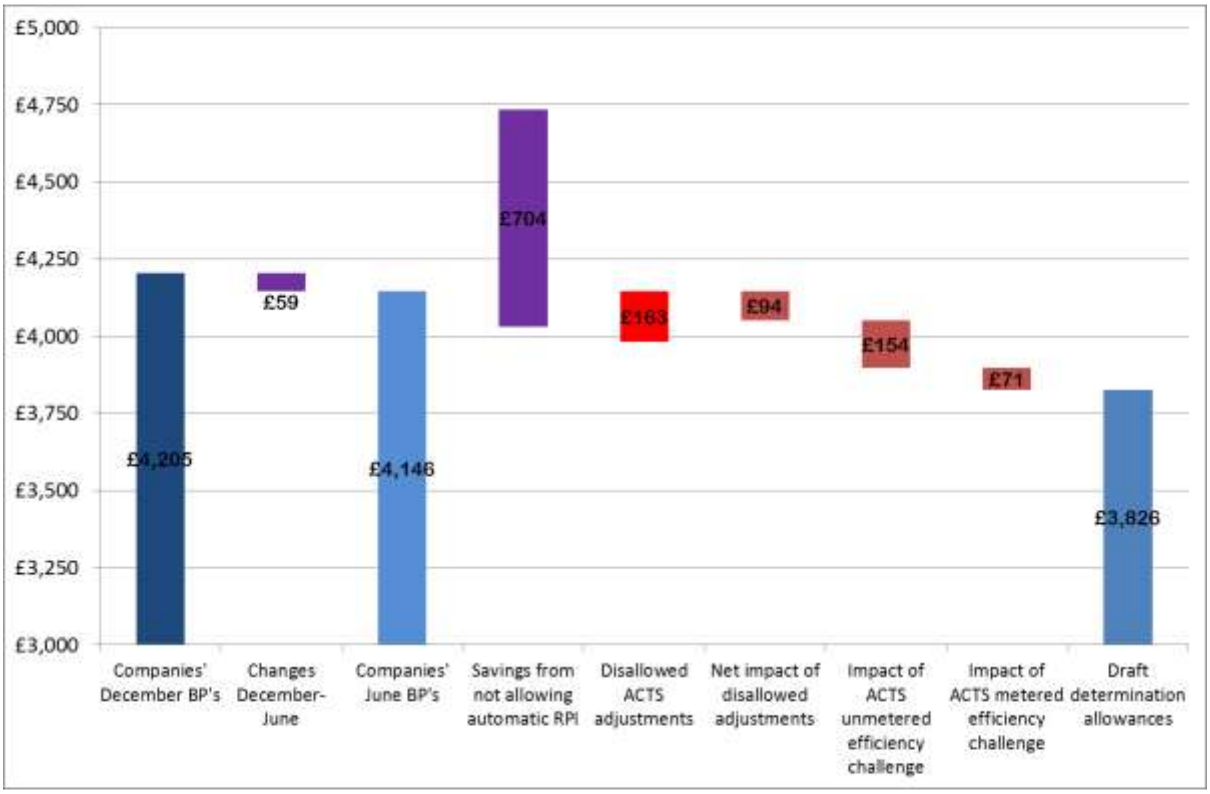
- **Since December companies have made reductions to their retail household costs totalling £59 million and better allocated their costs across customer groups.** Companies have also committed to continuing to provide service level protection for customers through the Service Incentive Mechanism (SIM).[2]

- **Applying our average cost to serve (ACTS) efficiency challenge and not automatically indexing retail price controls to RPI will benefit customers in the period 2015-20** as a result of the downward pressure we have brought on customers' bills.

- **We have made interventions worth £163 million to customers** on company claims for bad debt, input price pressure and new costs.

[1] The total savings for household retail are arrived at by comparing June business plans, less requests for input price pressure allowances plus forecast RPI, with the draft determination allowances. This difference is £909 million.
[2] In 'Service incentive mechanism (SIM) for 2015 onwards – conclusions' we set out how we propose to regulate using the SIM in the future.

Figure A4.1 Impact of our overall household retail efficiency challenge (£m, 12-13 prices)



Note:

All figures taken from companies' plans/our assessments. Figures shown in 2012-13 prices and include all companies (including those receiving early draft determinations). RPI savings figure is an estimate based on our independent advice of forward projections of RPI applied to companies' plans minus input cost pressure claims to avoid double counting – this overlaps the companies' June business plans column on the chart as some companies had included an allowance for inflation in their business plans. Disallowed ACTS adjustments include adjustments for pension deficits and new costs requested as adjustments. As rejecting a company affects the ACTS, and hence allowed revenues across the industry, the net impact of disallowed adjustments is shown separately. ACTS efficiency challenges are applied after removing ACTS adjustments.

The material we have published today sets out our draft proposals. Stakeholders now have the opportunity to comment on the proposals and the approach we have adopted in reaching our decision. We will consider carefully all of the representations ahead of making final determinations in December. In particular, companies will review whether to include further evidence as a result of the feedback we have given them. And we will maintain our high evidential bar to make sure that our final decisions represent the best possible deal for customers.

A4.1 Summary of indicative revenue forecasts

The table below summarises the revenues per company which arise from our household retail price controls. These allowances reflect our approach in allowing companies a three-year glide path down to the ACTS during 2015-20.

Table A4.1 Household retail revenue price control excluding net margins (nominal)

Company	Units	2015-16	2016-17	2017-18	2018-19	2019-20
Anglian	£m	69.4	71.9	73.8	75.2	76.5
Dŵr Cymru	£m	50.5	47.7	45.0	42.3	42.2
Northumbrian	£m	48.5	48.5	48.5	48.5	49.1
Severn Trent	£m	100.9	104.5	107.0	108.0	109.6
South West	£m	27.3	27.7	28.0	27.9	28.5
Southern	£m	53.4	51.5	49.4	47.4	48.7
Thames	£m	144.5	147.4	146.1	145.6	142.9
United Utilities	£m	112.7	107.7	101.8	96.8	98.4
Wessex	£m	26.9	27.2	27.7	27.9	28.3
Yorkshire	£m	51.0	52.4	54.1	55.8	57.7
Affinity	£m	25.2	24.9	24.5	24.0	23.9
Bristol	£m	8.8	9.1	9.4	9.6	10.0
Dee Valley	£m	2.6	2.6	2.5	2.5	2.6
Portsmouth	£m	4.1	4.2	4.2	4.3	4.3
Sembcorp Bournemouth	£m	4.2	4.3	4.4	4.5	4.5
South East	£m	18.2	18.8	19.4	19.9	20.5
South Staffordshire	£m	13.5	13.5	13.7	14.2	14.9
Sutton & East Surrey	£m	5.0	4.8	4.7	4.4	4.3

Note:

There will be no indexation for retail price controls from this price base.

Our assessment of the 14 companies now receiving draft determinations affects the industry ACTS, and hence the implied price controls of the four companies that received early draft determinations (Affinity Water, South West Water, Dŵr Cymru and Northumbrian Water). The values presented for these four companies in the table above are indicative of the allowed revenues they would receive at final determination, given the updated ACTS. They do not reflect any representations made by these four companies.

A4.2 Methodology

Our methodology for setting household retail controls includes three broad elements:

- an assessment of the allocation of costs;
- our approach to calculating the price control revenues; and
- an assessment of the overall levels of service within the control.

Each of these elements is described below, including how we carried out the assessment for the draft determinations and any calculations.

A4.2.1 Assessing the allocation of costs

It is important to robustly and consistently allocate costs between retail and wholesale and between household and non-household boundaries to ensure that

- comparative regulatory tools such as the ACTS apply fairly across companies; and
- there is a level playing field for companies and customers when the retail market opens for non-household customers in April 2017.

In our final methodology statement we set out our overall approach to setting household retail price limits including:

- the definition of retail services;
- our guidance on the allocation of costs; and
- the form of the price and service regulation we proposed to implement for household retail.

We updated our definition of retail activities in IN 13/10, 'Change to company business plan guidance for the 2014 price review – costs of scientific services' and clarified a number of comments and questions companies had about our methodology through a workshop discussion and by publishing 'Preparing business plans for 2014 price review – retail questions and answers'.

In December we received companies' initial business plan submissions and carried out a risk-based review of those submissions. During this review it became clear that companies had used different cost drivers for the allocation of certain costs across the different price controls. 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. We announced the results of our risk-based review in March and later published our internal methodology for the risk-based review.

However, our risk-based review analysis showed that some of the cost drivers that companies had used in their December business plans were less cost reflective than others. And that in some instances where different drivers were used, this resulted in material changes to the overall amount of costs being allocated to different controls. We were concerned that this could result in an inconsistent application of the ACTS methodology across companies and a less appropriate and reflective allocation between different customer groups – including between household and non-household customers. This could introduce unfair cross-subsidies between customers and reduce the effectiveness of the forthcoming non-household retail market.

So we set out new guidance on the allocation of costs. We stated in the new guidance that, where possible, companies should allocate their costs directly between retail and wholesale, and between household and non-household. Where this was not possible, we prescribed a consistent set of cost drivers that companies must use to allocate their costs between retail and wholesale, and between household and non-household.

We held another workshop with companies in April to take them through the new guidance and to update them on the results and issues arising from the risk-based review. And following queries from companies on the allocation of capital costs and depreciation, we emailed a further clarification to all companies in early June of how capital costs and depreciation should be allocated between price controls.

We also issued detailed checklists to companies to assist them in preparing their June business plan submissions. And we asked companies to provide us with reconciliations between their:

- June business plan submission and 2013-14 regulatory accounts; and
- June and December business plan submissions.

This enabled us to see a clear audit trail of changes.

As part of these draft determinations we have checked companies' compliance with the new guidance. In particular we have sought to identify areas where we consider that there are currently costs which may be misallocated according to the guidance – for example, because an inappropriate cost driver was used– and where those misallocations may be material (that is, result in misallocations amounting to greater than 2% of costs according to the thresholds set out in our risk-based review internal methodology).

We place significant weight on the external assurance companies provided. We do not have access to companies' internal systems and detailed costing information and we rely heavily on the assurance they provide over companies' cost allocations. So our assessment also considered the quality and nature of the external assurance companies provided.

Consistent with a proportionate and risk-based approach, if we still have concerns over some companies' cost allocation and/or adequacy of external assurance at final determination, we may put in place more onerous regulatory reporting requirements and/or a more onerous assurance regime from 2015-16 for those companies. We will be consulting on our revised approach to regulatory reporting from 2015-16 in September 2014.

A4.2.2 Calculating retail household price control revenue

Our approach to calculating the revenue controls for household retail services is consistent with our final methodology and our risk-based review internal methodology, which sets out our assessment criteria in more detail. Household customers will continue to receive their retail services from their local monopoly supplier and our approach therefore seeks to protect those customers by:

- challenging poor performing companies to reduce their costs; and
- avoiding unnecessary or poorly justified cost increases by companies that would impact on customer bills.

To achieve this, first we calculate companies' own costs to serve (CTS) in 2013-14 per unique customer for unmetered (unmeasured) customers. For this purpose, we exclude metering costs, as these are not relevant for the CTS of unmetered customers. We may also exclude some other company-specific adjustments from a given company's CTS, if it has provided sufficient and convincing evidence through its business planning submissions that these costs should be excluded.

We also assess whether the company has provided sufficient and convincing evidence to support the inclusion of additional new costs (including depreciation for new assets) in its calculated CTS. This is because the 2013-14 costs will not necessarily be representative of efficient costs to serve in the 2015-20 period. We isolate the company's new costs by taking into account increases in customer numbers and metering. This ensures that we do not assess material cost increases driven solely by growth in customer numbers and new connections or the roll out of metering.

If costs are immaterial, or material but well justified (see section below), then we do not change forecast costs. If new costs are material and are not justified, we reduce the company's base retail operating expenditure (opex) forecasts for 2015-20 to disallow new costs above the materiality threshold. A modification is made to the company's CTS in 2013-14 for the purpose of calculating the ACTS.

The definition of 'unique customers' for the purpose of deriving each company's CTS for unmetered customers includes a specific industry adjustment to account for the economies of scope benefits associated with providing both water and wastewater household retail services rather than separate water and wastewater services. This adjustment factor is set at 1.3. This is based on an analysis we carried out before publishing our final methodology. We have not seen sufficient and convincing evidence to suggest that there is a better figure or approach to use so we continue to use it in our assessments.

Adjusting the number of customers for economies of scope

Unique customers (adjusted for economies of scope)
= (1.3 x number of water and wastewater customers)
+ number of water only customers + number of wastewater only customers

On this basis, the calculation of each company's CTS for unmetered household customers is set out below.

Calculating modified cost to serve for unmetered customers

$$\text{Unmeasured CTS} = \frac{\begin{array}{c}\text{operating expenditure} - \text{metering costs} + \text{depreciation} \\ + \text{modification for new costs} \\ + \text{adjustments (if claim is not accepted)}\end{array}}{\text{(number of unique customers (adjusted for economies of scope)}}$$

Next, we calculate the retail ACTS for these unmetered household customers across all companies using the modified 2013-14 CTS as set out above for each company. We calculate this as an unweighted average – that is, a simple average across all companies' CTS which is not weighted to account for different-sized companies. This ensures that the ACTS efficiency challenge reflects evenly the activities of different companies' management to keep these costs down, and avoids weighting the average towards the largest companies (and their management practices).

We then compare each company's CTS for each year from 2015 to 2020 with the ACTS to provide an efficiency challenge.

- If a company's CTS is below the ACTS in any given year, then its allowed household retail revenue will be based on its own forecast CTS in that year.

- If a company's CTS is above the ACTS in 2018-19 and 2019-20, then its allowed household retail revenue will be based on the ACTS for those years.

- If a company's CTS is above the ACTS in 2015-16, 2016-17, or 2017-18, then its allowed household retail revenue will be based on the lower of:

  – the ACTS, with a straight line three-year glide path down from actual costs in 2013-14 to the ACTS in 2018-19; and
  – their forecast CTS in that year.

- If a company's CTS is above the ACTS in some years and below the ACTS in other years, then its allowed household retail revenue will be based on the lower of

  – the ACTS with glide path as described above; and
  – actual costs in each year.

This approach reflects our commitment in the methodology to a three-year glide path to the ACTS. After the efficiency challenge has been applied, any allowed adjustments (see section below) are added on to the allowed revenue per customer in each year.

These efficiency challenge rules are summarised in the following equation.

Efficiency challenge rule summary – unmetered

Allowed unmeasured CTS
= lesser of ((glide path (if above ACTS) or ACTS (if below ACTS)) AND forecast CTS)
+ allowed adjustments per customer

Once we have applied the efficiency challenge consistently to companies based on their retail costs, we then:

- remove depreciation related to pre-2015-20 assets (which will be remunerated by the opening regulatory capital value (RCV) used for setting wholesale controls);
- add back any allowed adjustments; and
- add on any other costs not subject to the ACTS efficiency challenge, for example pension deficit recovery costs for household retail, and outcomes costs specific to household services that are not related to industry-wide delivery incentives – such as SIM and the guaranteed standards scheme (GSS).

This produces an allowed retail cost per unmetered customer for each company.

A separate process is followed to derive the additional CTS for metered (or measured) household customers. This allows us to reflect the additional costs of providing retail services to metered customers, and avoids creating a disincentive to increase meter penetration because these additional costs cannot be recovered.

The additional metering CTS for each customer is calculated for:

- water only customers for WoCs and WaSCs;
- sewerage only customers for WaSCs; and
- water and sewerage customers for WaSCs.

This is calculated as the total additional costs of metering for each customer type divided by the number of customers.

The additional metering ACTS for each class of customers (water only, sewerage only, and water and sewerage) is then calculated as the unweighted average of the additional metering CTS for that customer class.

Each company's additional metering CTS for each year from 2015 to 2020 is compared with the additional metering ACTS for that type of metered customer to provide an efficiency challenge.

- If a company's additional metering CTS is below the additional metering ACTS in any given year, then its allowed household retail revenue will be based on its own forecast additional metering CTS in that year.

- If a company's additional metering CTS is above the additional metering ACTS in 2018-19 and 2019-20, then its allowed household retail revenue will be based on the additional metering ACTS for those years.

- If a company's additional metering CTS is above the additional metering ACTS in 2015-16, 2016-17, or 2017-18, then its allowed household retail revenue will be based on the lower of:

  – the additional metering ACTS, with a straight line three-year glide path down from actual costs in 2013-14 to the additional metering ACTS in 2018-19; and
  – their forecast additional metering CTS in that year.

- If a company's additional metering CTS is above the additional metering ACTS in some years and below the additional metering ACTS in other years, then its allowed household retail revenue will be based on the lower of:

  – the additional metering ACTS with glide path as described above; and
  – actual costs in each year.

On the above basis, the calculation of each company's additional metered CTS is set out below.

Calculating additional metered CTS

$$\text{Additional metered CTS} = \frac{\text{total metering cost}}{\text{number of unique metered customers}}$$

These efficiency challenge rules are summarised in the following equation.

Efficiency challenge rule summary – metered

Allowed additional metered CTS
= lesser of ((glide path (if above ACTS) or ACTS (if below ACTS)) AND forecast additional metered CTS)

The total allowed retail cost per metered customer, for each of the three groups, is then the allowed additional CTS calculated as set out above plus the allowed retail cost per unmetered customer as set out earlier.

Calculating total allowed retail cost per customer

Total allowed retail cost per metered customer
= allowed additional CTS + allowed unmeasured CTS

Having calculated the allowed retail cost of serving each customer type in each year, we then calculate the allowed net margin per customer. This is set based on the allowed retail costs per customer and the allowed wholesale revenue per customer. So, for each customer type, the total allowed retail revenue per customer is as follows.

Calculating total allowed retail revenue per customer

Allowed household retail revenue per customer by customer type
= [(allowed retail cost per customer by customer type
+ allowed wholesale revenue per customer by customer type)/(1
– household retail net margin)]
– allowed wholesale revenue per customer by customer type

The final step in calculating the total allowed household retail revenue estimated during the price review is to multiply the total allowed household retail revenue per customer by customer type by the number of unique customers of each customer type, for each year (that is, this includes an adjustment for economies of scope).

Adjustments to the ACTS

Our final methodology statement confirmed that companies could seek additional adjustments to their ACTS if they were able to demonstrate with sufficient and convincing evidence that:

- those costs were material to the company;
- they were driven by factors beyond efficient management control (having taken all the possible steps to control those costs); and
- they impacted the company in a materially different way to other companies.

Each of these criteria is of equal importance. The first ensures that adjustments to the ACTS are only made for material items. The second ensures that companies provide sufficient and convincing evidence that the particular factor was beyond management control, and that there was clear evidence of a causal relationship between that factor and the costs of providing retail services to household customers in their area. Similarly, companies needed to demonstrate under this criterion that their management practices in this area were efficient, or to reflect their level of inefficiency suitably in their adjustment request. The third ensures that adjustments to the ACTS are only made for items that impact companies in a materially different way to other companies, given that the ACTS will generally already take account of any items that impact all companies in the same way.

Adjustments for doubtful debt

There are likely to be a number of factors that, theoretically, could affect the overall level of doubtful debts that efficiently-managed companies experience, given their own circumstances. While the size of the bill and levels of deprivation among a company's customer base may affect the overall level of doubtful debts, there are a range of other factors, including management practice, which could also influence the overall level of doubtful debt among companies.

It is highly challenging to identify the extent to which the observed levels of historic doubtful debt costs are driven by inefficient management practices rather than by factors which are genuinely outside of management control. It is equally challenging to use the derived relationships as a basis for predicting future efficient doubtful debt levels, when the wider circumstances driving doubtful debt levels are expected to change over the business planning period – for example, as the broader economy improves.

To try and address this, we encouraged companies to use more sophisticated analytical approaches. Companies have used varying analytical approaches to make the case for an adjustment, given their own circumstances. Convincing analytical evidence is necessary, but it is not sufficient on its own for accepting any proposed adjustments. We would also expect to see a convincing economic argument that supports the findings of the analytical assessment, as well as convincing evidence of good management practices.

Adjustments for input price pressure

As we set out in our final methodology statement, we do not consider that automatic RPI indexation is appropriate for the household retail control. If companies think that they are affected by uncontrollable input price pressures, they must provide compelling evidence of them.

Evidence to support adjustment claims for input price pressure must demonstrate that the company is efficient (against the three criteria stated above) and this should include evidence benchmarking the company's retail activities or costs against comparators outside of the water sector because we consider efficient to mean efficient when compared to similar retailers in the broader economy.

A company must also provide evidence that it employs best management practices to control input price pressures. This evidence should demonstrate that input price pressures are beyond management control.

The adjustment requested for input price pressure should also be constructed in an appropriate way. It should be focused on the specific cost areas involved in household retail, and be based on appropriate specific cost increase measures. It should also take account of appropriate levels of efficiency.

New costs

Following discussion with companies (Retail price control workshop 26 September 2013 and Retail price control workshop 17 April 2014), we introduced a means of allowing companies to make a case for modifying their CTS to account for forecast 'new costs' if they considered that 2013-14 costs were not representative of ongoing costs.

To calculate new costs we accounted for growth in customer numbers and increased metering penetration. If new costs were found to be material companies were required to demonstrate with sufficient and convincing evidence that:

- the need for the cost is justified;
- the new costs reflect the most cost-beneficial solution to address the need;
- the cost estimates are robust; and
- customers are protected.

In general, claims for new retail costs needed to satisfy all of these elements to be accepted, but in some cases we used our regulatory judgement. This approach is consistent with the approach we followed in the wholesale cost assessment and the methodology we adopted during our risk-based review.

Net margin

In our risk and reward guidance, we confirmed that our view of an appropriate net margin was 1% for household retail price controls.

The retail net margin applies to total household costs. So it is applied to wholesale charges to supply households, plus allowed household retail costs.

Revenue modification

As we set out in our final methodology statement, we will make an automatic modification to allowed household retail service revenues in each year of the price control to account for the difference between actual and forecast customer numbers in that year. We will make this modification to allowed household retail revenues the equation below, and the modification factors and forecast customer numbers set out in each company-specific draft determination.

Modifying allowed household retail revenue services for actual customer numbers

Revenue modification (2015-16 to 2019-20)

$$= \sum_{y=1}^{5} \sum_{c=1}^{4} (\text{actual customer numbers}_{y,c} - \text{forecast customer numbers}_{y,c}) \cdot \text{modification factor}_{y,c}$$

Where

- **y** = years (2015-16 to 2019-20),
- **c** = customer type (un-metered, metered water only, metered wastewater only, metered water and wastewater),
- **customer numbers** are defined in unique customers – that is, each water and sewerage customer is weighted as being 1.3 unique customers,
- **forecast customer numbers** and **modification factors** are as set out in each company-specific determination.

Total allowed revenues are based on the number of customers and meter penetration set out in companies' business plans. If actual customer numbers or meter penetration differ from forecast values, then a modification will be made to allowed revenues to account for this.

These modification factors include an allowance for the net margin. This allowance is based on forecast nominal wholesale charges. These modification factors will not be updated for differences between forecast and actual nominal wholesale charges. This is because doing so would make the calculation of these modification factors, each year considerably more complex and less transparent. We consider that setting these modification factors out in advance and not varying them for changes in wholesale is a more proportionate approach.

For example, consider the case where the number of unmetered water only customers is lower than forecast, and the number of metered water only customers is higher than forecast as a result of a more rapid meter roll out than anticipated. We would make a downward adjustment for revenue for unmetered water only customers, and a more than offsetting upward adjustment for metered water only customers.

A4.2.3 An assessment of the overall levels of service within the control

As well as protecting customers through the prices they pay, we also need to ensure that service levels are maintained and improved in line with customers' expectations.

All household customers will continue to receive service level protection through the industry wide SIM, which has continued to prove itself to be an effective incentive for companies to offer good and improving service levels to customers. However, we have adapted this incentive to ensure that it continues to respond to customer preferences and encourage poor performing companies to improve in the service they offer to customers. In 'Service incentive mechanism (SIM) for 2015 onwards – conclusions' we set out how we propose to regulate using the SIM in the future.

Beyond the SIM, companies have been able to propose a number of tailored outcomes for their customers as part of their plans. Further information on the SIM and household retail outcomes can be found in our outcomes technical appendix and the company-specific appendices.

A4.3 Our assessment of companies' plans

Below we set out the high-level results of our assessment of companies' plans for these draft determinations. We present results across the first two elements of our methodology:

- our assessments of the allocation of costs; and
- calculating the price control revenues.

Further details on the results of our assessment of the overall levels of service within the control can be found in our appendix and the results for individual companies can be found in the company-specific appendices.

A4.3.1 Our assessments of the allocation of costs

Following our review of companies' June plans we identified a number of instances where companies had potential material cost misallocations, where their assurance was insufficient or where there were other problems with the information provided. We are concerned that:

- these issues are still occurring after we issued more detailed guidance earlier this year, held a workshop with companies to present and discuss the guidance and also held a number of bilateral meetings with companies where these were requested; and
- there is now limited time left to resolve these issues for the final determinations in December (this may be particularly important where companies require time to resolve them, for example by conducting sampling to develop more appropriate cost drivers).

We issued queries to address gaps in the information submitted by companies and, where necessary, to clarify companies' cost allocations. Where query responses from companies were either insufficient or unconvincing we examined the materiality of the potential misallocation such that:

- where we did not have the information to decide whether the issue was material, we used company information and have flagged in their draft determination the misallocation issues to be resolved; and
- where the issue was material and we had sufficient information to perform the re-allocation ourselves, we intervened in companies' plans and corrected allocations directly.

We will be reliant on information from companies being correct to be able to finalise cost allocations for final determinations. For example, although we may be able to see that an inappropriate cost driver has been used we need this to be corrected by companies because we are unlikely to know what the answer would be if a different cost driver were used or have a suitable proxy.

As a consequence of our concerns over the information and the timescales, we felt that the most sensible, proportionate and consistent approach would be to write to all those companies with a potentially material cost misallocation (and also highlighting where these companies had not provided us with adequate external assurance over their cost allocations). So we wrote to a number of companies highlighting the shortcomings in their cost allocations so that they have sufficient time to address these shortcomings and submit representations by 3 October.

The following companies with potentially material cost misallocations received letters from us – Yorkshire Water, United Utilities, Dee Valley Water, Portsmouth Water, Southern Water, South Staffordshire Water, Severn Trent Water, Sutton & East Surrey Water and Thames Water. All of these companies, with the exception of Sutton & East Surrey Water and Thames Water, also failed to provide us with adequate external assurance over their business plan cost allocations. Following this letter we have received assurance reports from two of the companies we wrote to – Severn Trent Water and Southern Water. We have reviewed those reports and set out our assessments in each company's draft determination but these will need to be ratified by our Board at final determinations.

We have highlighted each of the specific company issues and a list of questions in their individual draft determinations. Some common issues across the sector were:

- the existence, availability, transparency and scope of the assurance undertaken by companies;
- the allocation of doubtful debt costs between household and non-household customers where a number of companies had allocated these costs using debt write-offs or movement in outstanding debt as a suitable proxy; and
- the allocation of first visit to the customer/investigatory visits between retail and wholesale where a number of companies had allocated these costs wholly to retail

All of the issues highlighted for each company will need to be resolved for final determinations. Where we have identified gaps in external assurance, we expect companies to provide us with an external assurance report from a recognised assurance provider which confirms that business plan tables R3 and R4 have been completed in accordance with the table guidance and that **all costs** in R3 and R4 have been allocated to retail (between retail and wholesale) and between household and non-household in accordance with our guidance. In accordance with our guidance means in accordance with '2014 price review cost allocation for retail and wholesale price controls' which was published on 24 March 2014, further clarified in the area of investigatory visits/first visit to the customer by our 17 April workshop slides and in the area of capital costs and depreciation by the correspondence which we sent to all companies in early June.

We expect external assurance providers to perform substantive testing to source documentation as part of their testing of companies' cost allocations. This is because, as stated in section A4.2.2, we do not have access to companies' internal systems and detailed costing information and so we rely heavily on the assurance they provide over companies' cost allocations. Where companies need to further clarify our requirements in this area, we would encourage them to contact us as soon as possible.

We intend to consult on our ongoing regulatory reporting and compliance arrangements in September 2014 and this will include formally putting our cost allocation guidance into the ongoing regulatory reporting arrangements, including the regulatory accounting guidelines. This will ensure that the ongoing reporting requirements and guidance are clear for all companies going forward.

A4.3.2 Calculating price control revenues

When calculating companies' price control revenues we have needed to consider a number of requests for adjustments to the ACTS, and new costs, before calculating the overall ACTS using the methodology described in section 2.

ACTS adjustments and new costs

We have considered a number of potential requests for adjustments to the ACTS as part of the submissions from the 14 companies submitting business plans to us in June. These generally related to adjustments for factors affecting companies' levels of bad debt (five claims), such as bill size, levels of local deprivation or impacts of the Thames Tideway Tunnel (TTT), or requests for input cost pressure allowances (ten claims).

In the majority of cases we have not accepted these requests as the evidence provided was either insufficient, unconvincing or both. Across all the draft determinations that we have now issued, including the early draft determination companies:

- three companies have received an adjustment for factors affecting their levels of bad debt (South West Water, Dŵr Cymru and United Utilities); and
- one company has received an adjustment for input cost pressures in retail (Yorkshire Water).

All other adjustment requests were rejected.

We also reviewed new investments or cost increases across seven companies. One company (Anglian Water) provided sufficient evidence to justify material new costs in its household retail control and three other companies (United Utilities, Severn Trent Water and Thames Water) have had new cost allowances accepted in the draft determination but we have highlighted areas where we require further evidence ahead of final determinations. All other companies' claims for material increases (five companies) in their household retail costs were adjusted down to the materiality threshold. No interventions have been made for those companies where new cost increases are not material, or where costs are falling (nine companies).

The table below summarises which companies have requested and been granted ACTS adjustments and new costs.

Table A4.2 Household retail – proposed adjustments and new costs

Company	ACTS Adjustment – bad debt	ACTS Adjustment – input price pressure	New costs
Anglian			Accepted
Severn Trent	Rejected		Accepted*
Southern	Rejected	Rejected	
Thames	TTT - Rejected		Accepted*
United Utilities	Accepted		Accepted*
Wessex		Rejected	Rejected
Yorkshire		Accepted	
Bristol		Rejected	
Dee Valley		Rejected	Rejected
Portsmouth		Rejected	
Sembcorp Bournemouth		Rejected	Rejected

Company	ACTS Adjustment – bad debt	ACTS Adjustment – input price pressure	New costs
South East		Rejected	
South Staffordshire	Rejected	Rejected	Rejected
Sutton & East Surrey		Rejected	

Note:

* Allowed in draft determinations, but further evidence required for final determinations.

In the case of Southern Water we have also intervened to use the company's costs per customer for 2012-13 instead of those provided for 2013-14. The company had included a number of one off costs in 2013-14 that were not representative of ongoing costs. Because of this we have decided that the company's 2013-14 costs are not appropriate for using to calculate the ACTS or the company's allowed revenues and so we have used 2012-13 data as the next best proxy for their ongoing costs.

Industry-wide ACTS

Using the methodology described in section 2, we have calculated the industry ACTS for unmetered customers and the average additional ACTS for metered customers for these draft determinations using the submissions that all companies provided to us on 27 June. To arrive at the Industry ACTS for each customer type, we have:

- adjusted the allowed revenues per customer by the economies of scope factor, 1.3, for dual service water and sewerage customers; and
- added the additional ACTS for each type of metered customer to the single service and dual service ACTS to arrive at the total ACTS for the three types of metered customers.

We have set these out in the table below.

Table A4.3 Industry ACTS (£/customer, 2012-13 prices, two decimal places)

	Value
Industry ACTS for unmetered single service customers	20.73
Industry ACTS for unmetered water and sewerage customers	26.95
Industry ACTS for metered water-only customers	26.78
Industry ACTS for metered sewerage-only customers	24.04
Industry ACTS for metered water and sewerage customers	33.21

Using the average industry allowances per customer set out above, and the projected customer numbers in companies' revised business plans, we have calculated the total allowed household retail revenues in 2012-13 prices for each company. These calculations include the allowed uplifts for the efficiency glide path and the household retail net margin for each company as set out in annex 2 of the relevant company-specific appendix.

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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