March 2016

Trust in water

Draft statement of method and data table requirements
Review of non-household retail price controls

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About this document

From April 2017, 1.2 million businesses and other non-household customers of providers wholly or mainly in England will be able to choose their supplier of water and wastewater retail services[1].

The non-household (NHH) retail price controls were set from 1 April 2015 for a period of two years – taking account of representations from water companies that there would be advantages in reviewing these arrangements before the market opens in April 2017. In November 2015, we published an initial consultation[2] on this review; this draft statement of method builds on our earlier consultation by setting out our current thinking on key issues and next steps, including:

- our views on the issues raised by respondents to our November consultation, such as whether our review should retain the relatively narrow focus envisaged when we set the existing controls in December 2014, or whether we should consider wider issues (such as the overall level of cost and margin allowances for the NHH retail price controls);
- a possible approach to simplifying the form of the NHH retail price controls;
- our proposal for a three-year duration for the new NHH retail price controls; and
- a revised timetable for the review and more detail on information requirements and data tables.

We summarised our wider programme of work on protecting customers in the new retail market in the information notice (IN 15/12)[3] we published last September on the opening of the retail market.

[1] Retail services include billing, meter reading and other customer services.
[2] 'Consultation on the review of the non-household retail price controls', Ofwat, November 2015.
[3] IN 15/12, 'Opening a new retail market for non-household customers – protecting customers', Ofwat, September 2015.

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1. Overview

In 2014, the UK Government put in place legislation to enable the introduction of competition to the water sector. The ability to switch water and sewerage retailer will mean that eligible customers are free to choose the best package of prices and retail services that suits their needs. It will also provide opportunities for:

- innovation to flourish;
- the most efficient retailers to grow; and
- the development of new water management and efficiency services.

Our December 2014 price review (PR14) final determinations set the non-household (NHH) retail price controls that will operate between 1 April 2015 and 31 March 2017 for the 18 major companies holding appointments as water or water and sewerage undertakers under the Water Industry Act 1991. The two-year duration for these price controls took into account representations from water companies that there would be advantages in reviewing these arrangements before the market opens those providers of NHH retail services (wholly or mainly) in England from April 2017.

As we explained in our consultation, this review aims to ensure that the NHH retail price controls do not create undue barriers to entry or expansion, or restrict the ability of customers to secure deals with the retailer that best meet their needs. At the same time, we need to ensure that protections are in place to promote trust and confidence in the delivery of vital water and wastewater services. Experience from other sectors suggests that in the transition to full competition there will be a need for continuing regulatory protections to shield customers from potential abuse associated with remaining pockets of substantial market power.

This document:

- sets out our current thinking on the scope of the review;
- discusses an option for simplifying the form of control;
- proposes a three-year duration for the next controls;
- presents a revised timetable for the review; and
- sets out draft data tables.

It also includes key questions for consultation and proposals, which we set out in section 1.1 below. As well as responses to these questions, we welcome views from stakeholders on any other matter they consider important.

1.1 Consultation questions and proposals

Q1 We welcome views on our assessment of NHH retail cost to serve and the initial conclusion that an adjustment to the overall level of NHH retail cost allowances is not required.

Q2 We welcome views on our assessment of net margins and the initial conclusion that a 2.5% net margin remains appropriate.

Q3 We welcome views on whether there are sufficient difficulties and complexities associated with the present arrangements to justify simplifying the form of the control by introducing uniform caps on the NHH gross margins for larger sites.

Q4 If we adopt such uniform caps, how should the level of gross margin be calibrated and what consequential adjustments should be made (if any) to the remaining default tariff caps that would apply to smaller sites?

Q5 If we do not proceed with simplifying the form of control, we welcome views on how we could ensure appropriate allocation of costs and margins and prevent any inappropriate reallocation of costs and margins to individual default tariff caps. In particular, whether we should require compelling evidence that both supports revised allocations and shows that the existing allocations would act as a detriment to competition, before accepting any revised allocations of costs and/or margins?

Q6 How we should deal with differences between our PR14 final determinations and the present eligibility criteria in respect of categorising HH and NHH customers (that is, which customers will be able to participate in the competitive market)? In particular, whether we should change the definitions of HH and NHH customers in the RAGs (with effect from April 2017) so allowing the automatic adjustment mechanisms within the existing HH and NHH price controls to adjust revenues for these changes in customer numbers?

Q7 We welcome views on whether the following approach to the provision of information by incumbent companies as part of this review is appropriate:

- companies retain ownership of tariff setting and compliance with competition law and so we will not require third party assurance on these matters;
- companies will need to justify and provide and publish evidence supporting their allocations of historical costs to their default tariff caps and showing why any revised allocations would not be a detriment to competition;
- if companies are making proposals for changes to default tariff caps that would change tariffs and have significant incidence effect these will need to be supported by customer engagement; and
- all companies will be required to provide a Board assurance statement in relation to the meeting of their legal obligations, customer engagement and that information on cost allocations and attributions and other data is reasonable and robust.

We are also proposing that the duration of the next NHH retail price controls should be three years. We are not consulting further on this issue given the strong level of support for this proposal when we raised it in our consultation.

You can email your responses to NHHRetailPriceReview@ofwat.gsi.gov.uk or post them to:

Phil Griffiths
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Phil Griffiths on 0121 644 7615 in the first instance.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that your response should remain unpublished. Unless there is a clear reason why your response should be confidential and not be published, we may give less weight to such responses in reaching our decisions in matters related to this review.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice', which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

2. Background

This chapter provides background information on the PR14 NHH retail price controls and summarises the key questions raised in our consultation.

2.1 The NHH retail price controls

At PR14, we moved away from price controls covering the whole of the water and wastewater supply chains, and set separate price controls for:

- wholesale water;
- wholesale wastewater;
- household (HH) retail; and
- NHH retail.

The NHH retail price controls are called 'default tariff caps'. These are caps on the retail component of final tariffs (which also provide for the recovery of wholesale charges), and include an allowance for retail costs and margins for each customer. We designed this form of control to protect customers for the two years ahead of market opening, and to provide backstop protection and a comparison point for customers once the market opened.

These controls cover only the existing tariff structures. They will not apply to any new innovative tariffs that emerge with the development of competition. We intend the default tariff caps to provide transitional protection for customers until competition is sufficiently developed so that when combined with other enduring aspects of regulatory framework (for example, codes of practice on consumer protection – including in relation to the provision of information and fair dealing) the interests of customers are properly protected.

We based our default tariff caps on projections of:

- an allowance for NHH retail costs;
- the charges for wholesale services, which are collected by NHH retailers on behalf of the wholesaler (necessary so we could calculate retail margins); and
- the retail net margin to provide for the efficient financing of capital employed in providing NHH services and reasonably remunerate risk (which we set at 2.5% for companies operating wholly or mainly in England).

For each company, we based their NHH retail costs on 2013-14 costs, with certain adjustments specifically approved by us as part of the PR14 review process. Each company then took the lead in allocating NHH costs and net margins to individual default tariff caps.

Because the default tariff caps relate to the retail component of tariffs (or groups of tariffs), this form of price control has created a degree of complexity with more than 250 default tariff caps in total.

2.2 Consultation on the review of NHH retail price controls

Our consultation sought stakeholders' views on the scope of our review of the NHH retail price controls. In particular, we asked whether we should limit the scope of our review to that envisaged in our PR14 final determinations, with companies only able to refine their NHH retail cost and margin allocations between the default tariff caps to ensure they were cost reflective and compliant with competition law and other obligations[4]. We also noted that wider issues – including the overall level and allocation of costs and margins, and the scope for deregulation – could be considered at the next price review (at which time we would expect there to be clear evidence on how competition is developing).

Our consultation also sought stakeholders' views on:

- how best to improve transparency in the mapping of tariffs to the default tariff caps;
- whether there would be advantages in greater consistency in the default tariff caps across companies;
- what information companies should be required to provide and publish to support any proposed change to their default tariff caps;
- whether companies should have the option not to update their cost and margin allocations;
- whether a three-year duration would be appropriate for the next NHH retail price controls; and
- the timetable for our review.

[4] These obligations include those from competition law, the charging scheme rules established by Ofwat under section 143B of the Water Act 1991 and licence condition E that prohibits undue discrimination or preference in setting charges.

We received 28 responses to our consultation and in appendix 1, we set out a high-level summary of these. We have also published the individual responses alongside this consultation.

3. Method

This chapter discusses key aspects of our approach to setting price controls.

- Section 3.1 summarises our proposed approach to the scope of our review, including whether we should consider the overall level of the allowances for NHH costs and margins.

- Section 3.2 sets out an option for changing the form of the price control that could:
  - simplify the approach to regulating default tariffs;
  - help encourage competition; and
  - avoid undue focus on the allocations of costs and margins to individual default tariff caps.

- Section 3.3 discusses the eligibility criteria that determines whether customers can participate in the NHH retail market and how we should manage changes in company estimates of the number of eligible customers.

- Section 3.4 sets out our proposals for a three-year duration control, based on the suggestion in our consultation and the views of respondents.

3.1 Scope of our review

Our PR14 final determinations set the NHH default tariff price caps for a period of two years so that we could review the allocations of retail NHH costs and margins ahead of market opening in April 2017. Our consultation indicated that this remained our starting point but that we would remain open to considering wider issues if this allowed us to better meet our statutory duties (including protecting the interests of customers, where appropriate through promoting competition).

In response, a number of the incumbent water companies suggested that it would not be appropriate to extend the scope of our review. However, other respondents suggested that the overall allowances (rather than just the allocations to specific default tariff caps) for NHH retail costs and margins may be too low and might limit competition, and two potential market entrants made detailed representations in relation to these matters.

It would appear to be in customers' interests to analyse further the evidence in relation to the overall level of NHH costs and margins – and whether we should widen the scope of this review. In particular, a number of respondents suggested that the level of costs and/or margins allowed in the NHH retail price controls are inconsistent with allowing the proper development of competition (and the benefits that this may bring to consumers), and may create a margin squeeze on new entrants.

In the following sections, we address the key issues and evidence that respondents cited in relation to the overall level of costs and margins. In doing so we have been mindful of the clear advantages in regulatory stability associated with not re-opening issues linked to the wholesale and HH retail price controls, which were set for a period of five years from April 2015. We also need to ensure that we properly protect the interests of customers in the period until competition is fully effective. This suggests that before we consider making any higher allowances for NHH retail costs and/or margins we would need to be satisfied that:

- there is new information on the appropriate level of NHH costs and margins, as we do not intend to simply revisit the judgements on information and evidence provided at PR14; and
- any new information includes strong evidence of both higher costs and a detriment to competition, demonstrating that the existing allowances would not be in best interests of customers.

3.1.1 Cost to serve

As outlined in our consultation, the PR14 final determinations required companies to absorb the impact of inflation on the future level of allowed retail costs. On this basis, we assumed that the aggregate base level of retail costs for each year of the 2015-20 period remained in line with 2013-14 costs, with some further specific adjustments approved by us as part of the PR14 process to give total allowed NHH retail costs. Companies then took the lead in allocating these costs to each default tariff price cap.

Our consultation also explained that we had started to review the information that had become available after December 2014 on NHH retail costs, and that our initial analysis suggested there was no compelling evidence that we should change our approach. However, we noted the representations from potential market entrants that:

- in the energy retail sector, where competition was introduced more than 15 years ago, the average cost to serve NHH customers is much higher than the allowances made in setting the default tariff caps;
- in the energy retail sector, as well as higher costs, NHH retail businesses have higher earnings before interest and tax (broadly equivalent to the Ofwat allowance for net margin) and that these higher margins are after the impact of price discounting;
- in the water sector, NHH retail costs rose in 2014-15; and
- the NHH retail price controls that we set in December 2014 did not include a sufficient allocation of costs or margins.

We indicated that we would consider these matters alongside the responses to our consultation.

A number of respondents to our consultation raised related concerns about the overall level of NHH retail cost allowances. As well as making comparisons with energy retail and increases in water NHH retail costs in 2014-15 (noted above), respondents suggested that:

- the PR14 efficiency assumptions were too stringent and/or did not take proper account of the costs associated with operating in a competitive market;
- the PR14 cost allowances per company are highly variable, and that this variation is more likely to result from questionable allocations rather than real underlying cost drivers or efficiency;
- insufficient costs have been allocated to NHH retail activities; and
- the costs associated with changes in market arrangements since PR14 have not been properly taken into account.

We have considered these issues, including the evidence that respondents provided. We summarise our initial conclusions on cost to serve below (and summarise our initial conclusions on net margins in section 3.1.2).

Energy market comparisons

It is not straightforward to compare the costs of providing services across sectors, and it is not clear that comparisons with the energy sector will yield strong evidence on the appropriate level of costs in respect of water and wastewater NHH retail services. We also note that there are very large absolute differences between the costs of the big six energy suppliers' retail services and evidence of continuing restructuring in the energy sector. The three suppliers with the lowest costs (E.On, SSE and Scottish Power) have an average cost of £153 compared with the sector average of £291.

Therefore, there is a wide range of possible cost levels within the energy sector and it is not clear which of these is most relevant to compare with the water sector. However, we have carried out some analysis of the differences in NHH retail costs between water and energy.

At a high level, NHH retail costs as a percentage of turnover are broadly consistent across sectors. In relation to the big six energy suppliers, the equivalent of NHH retail costs average 5.1% of turnover[5] compared with 5.1% for water and sewerage companies (WaSCs) and 5.9% for water only companies (WoCs)[6].

Such segmental analysis is not generally available for independent energy suppliers, but we have reviewed the limited amount of information that is available in the statutory accounts of Opus Energy, an independent operator in the business-to-business (B2B) energy supply market. Its operating costs are higher at 9.3% of turnover[7]. But this appears to relate to its particular customer offering (including providing smart meters to customers), and that it was operating below its target scale (so will not be taking full advantage of economies of scale and will have higher customer acquisition costs). We have also been clear that the default tariff caps relate only to the existing tariffs and costs, and not to new innovative tariffs and the associated marketing costs.

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[5] 2014 consolidated segmental statements for Big 6 gas and electricity companies, available at: https://www.ofgem.gov.uk/publications-and-updates/energy-companies-consolidated-segmental-statements-css. The calculation is the total non-domestic indirect costs for 2014 (gas and electricity) for the big six energy companies divided by the total non-domestic revenue for 2014 (gas and electricity) for the big six expressed as a percentage. £866 million/£16,847 million = 5.1%.
[6] Based on 2013-14 regulated accounts for the WaSCs (excluding South West Water because of incomplete data and Dŵr Cymru because of different competition arrangements), total operating expenditure – excluding third party services divided by total NHH revenue expressed as a percentage. £86.9 million/£1,706 million = 5.1%. For WoCs (except Dee Valley Water), the same data has been analysed. £10.4 million/£174 million = 5.9%.
[7] Opus Energy Limited 2014 statutory accounts. The calculation is the total operating expenditure divided by total revenue expressed as a percentage. £28 million/£302 million = 9.3%.

As well as percentage comparisons of cost to serve, it is important to consider absolute costs, as average bill levels in the energy sector tend to be higher than in the water sector. With this in mind, we have analysed the average cost to serve in energy (indirect costs excluding depreciation and amortisation per cost customer) against the average in the water sector (operating expenditure excluding third party services – therefore excluding depreciation and amortisation – per customer). Where appropriate, we have attempted to take into account the different levels of average bill, which can have a significant impact on bad debt costs.

As noted above, the average electricity indirect costs per non-domestic electricity account reported by the big six energy companies in their 2014 consolidated segmental statements is £291[8], with the three lowest-cost suppliers having average costs of £153. However, both these benchmarks are significantly above the operating expenditure for NHH water and wastewater billed properties, which is £41[9], as reported by eight WaSCs[10]. There are a number of factors that explain these differences.

- There are greater economies of scope to be achieved in water and wastewater as the two services are regularly combined onto one bill. Assuming that the higher of the water billed properties and the sewerage billed properties better represents the total number of customers, the operating cost per customer is £78[11].

[8] £291 is the total electricity indirect costs for the big six companies divided by the total number of electricity customer supply points.
[9] £41 is the total operating expenditure excluding third parties for the eight WaSCs divided by the sum of the number of billed water properties and sewerage properties.
[10] We have excluded South West Water as no data was available for debt management costs, which skews the total operating expenditure number. We have also excluded Dŵr Cymru as the competition arrangements differ to other incumbent companies.
[11] The comparison of electricity retail costs to a £78/customer cost in the water sector is arguably a better point of comparison, as the number of billed properties and supply points in electricity are the same. Where customers take both gas and electricity (dual fuel), then combined electricity and gas retailing costs can be spread over fewer discrete customers, thus lowering retail costs per supply point. However, electricity and gas retailing activities have been historically more separate than for water and sewerage (and segmented data is available separately for electricity and gas), so we do not adjust the electricity cost per account for this.

- There is a range of options across both water and energy to manage doubtful debt and debt management costs for NHH customers. We also see a strong correlation between revenue per customer and total debt costs in water. Assuming that this is also observed in the energy sector, this suggests debt costs may be approximately £143 per customer higher[12].

- For metering costs, we note that Ofgem found[13] that meter charges in the non-domestic gas market reflected the costs of purchasing and installing meters as well as a number of other costs – maintenance, replacement of faulty meters, return on investment and protection against the risk of de-appointment by suppliers (which is also managed by termination charges). Ofgem also estimates that metering costs currently account for approximately 2.4% of the average non-domestic gas bill, which, based on the 2014 consolidated segmental statements for the big six energy companies, equates to a £84 average metering charge per meter point[14]. The average meter reading cost per customer per year is approximately £5 for the WaSCs. Because of the complexity of gas meters, we consider that the costs associated with such metering are likely to be higher than the costs of metering in electricity. However, as all metering charges are covered by the supplier in electricity, it is reasonable to expect notably higher metering charges when compared to the water sector.

- The limited evidence that we have available suggests that complaints per customer tend to be higher for the big six energy suppliers than for WaSCs[15], which may reflect the greater complexity of arrangements in the energy sector and the higher level of average bills.

[12] The proportion of revenue per customer for WaSCs is 24% of the big six electricity companies (£1,524/£6,389). Therefore, for debt management and doubtful debts we have calculated the WaSC average of £34/customer multiplied by 1/0.24 to calculate the estimated electricity cost per customer.
[13] Review of the non-domestic gas metering market in Great Britain, Ofgem, March 2016.
[14] Consolidated Segmental Statements published by Ofgem in 2014 for Centrica, RWE npower, EDF, E.ON, SSE and Scottish Power yield a combined average non-domestic gas bill of £3 484 (https://www.ofgem.gov.uk/publications-and-updates/energy-companies-consolidated-segmental-statements-css).
[15] Complaints per domestic customer are 59% higher for energy companies. Separate information on NHH complaints does not appear to be available. Data sources: CC Water, Delving into Water, Performance of the water companies in England and Wales 2010-11 to 2013-14, available at: http://www.ccwater.org.uk/wp-content/uploads/2015/01/Company-performance-report.pdf, Ofgem, Six large suppliers: Complaints received by energy company per 100,000 customer accounts, available at: https://www.ofgem.gov.uk/chart/six-large-suppliers-complaints-received-energy-company-100000-customer-accounts.

- Costs in the energy sector include marketing and customer acquisition costs that we have excluded from the default tariff caps, as these caps only apply to the existing set of tariffs and not new tariffs designed for the competitive market.

We are aware that the comparisons we have outlined above are not straightforward. Costs per customer in energy may be estimated at between £152 and £291; and in water and wastewater between £41 and £78, giving overall differences of between £75 and £250 per customer. Because of higher bill levels in energy, bad debt costs are likely to represent a significant part of these differences. Other explanatory factors are likely to include differences in metering and complaint handling costs. We have also explained that the default tariff caps relate only to existing customers and are not designed to recover marketing or customer acquisition costs. It is not straightforward to reconcile or fully understand the differences between sectors, but there appear to be factors that explain why the absolute cost to serve in the energy sector is significantly higher than in the water sector.

Costs increases in 2014-15

Because we designed the NHH retail price controls as a transitional measure to protect customers during the development of competition, they were set on a different basis to wholesale or HH retail price controls. Rather than basing them on benchmark comparisons, we based them on cost levels in 2013-14. Some respondents to our November consultation have suggested that because of this approach, we should update the controls for changes in costs between 2013-14 and 2014-15.

We have analysed company retail costs between 2013-14 and 2014-15, and have found that the weighted average increase across all WaSCs and WoCs is 14%. NHH retail costs increased by more than 20% for five companies, while costs for four companies decreased. We have assessed the reasons for the cost increases for four of the five companies (we have excluded Dee Valley Water) that have experienced the biggest rises.

- **United Utilities'** NHH retail costs increased by 23% over the year. This was mainly attributable to an increase of £4.5 million in doubtful debts, partly following a review of NHH debt provisions in preparation for system upgrades ahead of market opening. This appears to be a one-off change rather a general increase in cost levels.

- **Northumbrian Water's** NHH retail costs increased by 24% because of increases in customer service costs (as a result of increased account management costs), debt and debt management costs (as a result of specific provisions in NHH for older debt) and other operating expenditure (as a result of a higher allocation of general and support costs).

- **Thames Water's** NHH retail costs increased by 25%. Its accounting separation statement suggests that this is largely because of redundancy and reorganisation costs incurred when the company reorganised its operations in readiness for the 2015-20 regulatory period and changes in the accounting treatment of customer-side leakage costs.

- **Bristol Water's** NHH retail costs increased by 33%, largely because of a £0.3 million increase in bad debt costs. But because its HH retail costs reduced by a similar amount overall, its bad debt costs remained unchanged.

The companies that experienced reductions of costs were:

- South East Water;
- South Staffordshire Water;
- Wessex Water; and
- Yorkshire Water.

Costs reduced by between 3% and 14%.

It is clear that cost changes across the sector are very asymmetric. The biggest cost increases are confined to a small number of companies and appear to relate largely to bad debt costs. These appear, in part, to be driven by one-off changes in accounting provisions rather than changes in underlying cost trends. There does not appear to be evidence of widespread increases in costs driven by factors outside the control of management. On this basis, the changes in costs between 2013-14 and 2014-15 do not appear to constitute sufficient evidence to warrant the changes to the overall levels of the NHH retail price controls.

PR14 efficiency and inflation assumptions

To assess whether the efficiency and inflation assumptions used to set the NHH price controls remain appropriate, we have:

- reviewed evidence from the Scottish market;
- compared PR14 allowances with company business plans; and
- considered the impact of inflation.

Evidence from the Scottish market supports our view that the introduction of competition (which in Scotland occurred in April 2008) has the potential to reduce costs and generate significant cost savings. For example, before the market opened in Scotland, the Water Industry Commission for Scotland (WICS)[16] found that Scottish Water's costs compared reasonably well against many water companies in England and Wales. By 2010, Business Stream's NHH retail operating costs as a percentage of NHH revenue were the second lowest in a comparison with water companies in England and Wales.

Looking back to PR14, only five companies received cost allowances more than 5% below their original business plans and all companies had the opportunity to make representations to show that their efficient costs were necessarily above our allowances and so warranted an increase in costs. Three companies were successful in making such representations.

The size of the efficiency challenge that companies faced has also been effectively reduced by lower than expected inflation. PR14 assumed an (Retail Prices Index – RPI) inflation level of 2.80% (the assumed efficiency challenge at the time) and Office of National Statistics data shows that inflation has been below this level for the past two years (2.38% and 0.98% in 2014 and 2015, respectively). In addition, the Office of Budget Responsibility forecasts show that inflation is expected to remain below this level in 2016 at a rate of 2.00%. Therefore, we consider that the efficiency and inflation assumptions set at PR14 remain appropriate.

On balance, the evidence does not support revising the efficiency and inflation assumptions used at PR14.

Variations in cost allowances by company

Analysis undertaken by Ernst & Young in 2013 suggested that the costs companies incurred for customer service activities were, in the main, robust and comparable[17]. While Ernst & Young identified some inconsistencies in costs and cost allocations across companies, it noted that the impact on the cost to serve was relatively small.

[16] 'Retail competition: The story so far, the journey to come', Water Industry Commission For Scotland, November 2011
[17] 'Targeted Review of Accounting Separation Cost Allocations, Report of findings', Ernst & Yong, 28 May 2013.

Ernst & Young's report explained that the variations in costs between companies might be the result of differences in company structures, processes or activities rather than differences in cost allocations. It suggested that costs per customer across companies might vary because of differences in:

- the treatment of overhead costs as a result of differences in the management of core customer service activities – varying between fully outsourced, internally outsourced or managed internally;
- efficiencies of scale for companies that operate in both the HH and NHH markets;
- customer service operations, including the number and location of staff;
- the levels of meter penetration; and
- the approaches to debt management.

We recognise that there are some significant variations in the PR14 cost allowances on a per customer basis. But we take significant comfort from the Ernst & Yong work on cost allocations. There are a number of plausible explanations for the differences in companies' cost allowances, including:

- customer mix;
- wholesale charges (with higher overall charges driving higher bad debt costs); and
- companies' structures, processes and efficiency.

We note that following market opening, companies with high cost structures and inefficient processes are likely to come under increasing pressure to reduce costs, innovate and better reflect customers' requirements.

New costs

A number of respondents said that new costs had emerged since PR14 that were not properly allowed for in the 2014 price controls – in particular, market operator costs – but also other categories of cost. We consider these in more detail below.

Market operator costs

There are two main categories of costs associated with preparing for market opening – set up costs[18] and ongoing costs[19].

- **Set up costs.** While the Open Water programme has recently revised the estimate of these costs upward[20], the market blueprint[21] notes that wholesalers should pay these costs. As wholesalers will incur these costs, they should have limited impact on NHH retail costs and therefore no additional allowance appears necessary.

- **Ongoing running costs.** The Open Water programme has recently revised these costs downward[22]. The allowance made for these costs in PR14 (where, in most cases, we split them 50:50 between wholesale and retail) are based on the original, higher estimate. As the allowances made for these costs at PR14 are now above the revised costs, we see no reason to consider an upward adjustment for these costs.

Other costs

- **Marketing and customer acquisition costs.** We did not allow these costs at PR14 as we expected companies to recover them through innovative pricing and tariffs, and improved efficiency. We understand that in setting price controls for competitive retail activities in Scotland WICS has previously allowed for some of these costs, but we do not regard this as undermining the approach we set out in our PR14 final determinations.

- **Customer discounts.** These are not true costs but lower prices (determined by companies on a discretionary basis) and may be associated with particular marketing strategies. We expect these to be funded in a similar way to marketing and customer acquisitions costs.

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[18] These costs include costs of running Open Water programme, costs of setting up the Market Operator (MO) and costs incurred by market participants in preparing for market opening.
[19] These costs include the running costs of the MO in the future and additional work that we must carry out to regulate the new market.
[20] See the Open Water programme's 'Revised budget for implementing the new water and wastewater retail services market in England', 30 June 2015.
[21] Open Water Market Blueprint, 2 January 2014.
[22] http://9208a6bdb79020ec0337-99614e491dc8efff25f017339872a32a.r86.cf3.rackcdn.com/wp-content/uploads/2014/07/pap_con20140714s13licencer1.pdf

- **Bad debt costs.** We made allowances for these costs at PR14. We are aware that some companies have reported greater bad debt provisions and cost in 2014-15, but have seen no persuasive evidence that suggests the underlying level allowances made at PR14 were too low.

- **IT costs.** We allowed general IT costs at PR14, but we did not make specific allowances for IT separation costs, as there was no regulatory requirement for separate wholesale or retail systems. We understand that in Scotland, there were greater requirements for separation and some additional IT costs were allowed. But in England and Wales, we are not imposing requirements for separation (and at PR14 companies did not make proposals for this), so there appears to be no strong arguments for additional cost allowances. In addition, all companies (including new entrants) can contract out IT provision and seek to capture wider economies and efficiencies.

- **Costs of complexity.** While there are new processes associated with market opening, we are seeking to ensure that processes and any associated regulatory burdens are reasonable and proportionate. We have allowed market set-up and ongoing costs as discussed above.

Business Stream also highlighted that costs in a competitive market may be higher and compared Anglian Water's and United Utilities' operations in Scotland with their operations in England. It found that both companies' retail costs as a percentage of revenue and £ per customer were higher in Scotland than in England. However, there appear to be a number of weaknesses with this analysis.

- United Utilities is a relatively new entrant in the Scottish market and its retail costs have decreased from 30% to 15% of turnover in just two years (2013-14 to 2014-15). Its costs may not have yet stabilised and may decrease further as its business matures.

- Both Anglian Water and United Utilities may have targeted larger, higher-cost, high-margin customers in Scotland. This suggests they will have relatively higher costs to serve on a per customer basis.

- Anglian Water Business (AWB National) Limited's annual report for the year ending 31 March 2015 states that it provides water and sewerage services to NHH customers outside the Anglian Water region – in particular, those in Scotland. Its annual report also states that its retail arm (AWB) has taken major steps towards preparing for when England and Wales opens up to competition for NHH customers in 2017. Taken together, this suggests that it may be incurring additional market development costs on behalf of the appointed business, therefore showing higher costs in AWB.

Conclusions

The analysis set out above, which includes the assessment of the evidence that respondents provided to our consultation, indicates that no adjustment to the overall level of NHH retail cost allowances is required. In particular:

- there are a range of factors that explain why the absolute cost to serve in the energy sector is significantly higher than in the water sector;
- in 2014-15, some companies experienced cost increases and others experienced reductions; the causes of the cost increases appear to be company-specific factors and not external factors outside of the control of management;
- there is significant scope for efficiency improvement and innovation by companies;
- actual and expected inflation is lower than anticipated at PR14 so that the PR14 efficiency challenge should be easier rather than more difficult to achieve;
- analysis by Ernst & Young suggests that companies have adopted a reasonable approaches to cost allocation; and
- new costs proposed by stakeholders are not relevant, have moved in the opposite direction to that suggested by companies or have not been supported with evidence.

Consultation question

Q1 We welcome views on our assessment of NHH retail cost to serve and the initial conclusion that an adjustment to the overall level of NHH retail cost allowances is not required.

3.1.2 The retail margin

Our PR14 final determinations included a net margin to secure the efficient financing of capital employed in providing NHH services and reasonably remunerate risk.

A number of respondents to our consultation expressed reservations about the 2.5% net margin that we had allowed at PR14, with specific concerns that the margin would be insufficient to:

- allow a retailer to be financeable in its own right as a stand-alone business;
- properly allow for working capital requirements, including new working capital obligations that have emerged since PR14 or are likely to emerge;
- encourage effective competition;
- attract new entrants; and
- compensate market participants for the risk associated with operating in the market.

Below, we set out our analysis of these issues and the evidence provided by respondents.

Net margin is insufficient for a retailer to be financeable in its own right as a stand-alone business

A small number of respondents suggested that the 2.5% net margin allowed at PR14 was insufficient for a retailer to be financeable on a stand-alone basis. However, they did not provide substantial evidence in support of these suggestions.

We set the 2.5% net margin at PR14 based on a range of considerations, including a study by PwC (summarised in the following section) of the appropriate margin for a NHH retail business.

More recent analysis that the Competition and Markets Authority (CMA) has carried out into the energy market also suggests that a 2.5% net margin for retail activity remains broadly appropriate. Provisional Findings from the CMA's Energy Market Investigation suggest that margins in the range of 1% to 3% provide a guide to the competitive Earnings Before Interest and Taxes (EBIT) margins. In particular:

> "… that the current EBIT margins generated by mid-tier suppliers would be impacted by higher acquisition costs and upfront investment as they expanded their customer base and business, [and it] considers that the mid-tier suppliers face sufficiently similar cost structures and risks to those of large suppliers as to provide useful information as to likely levels of competitive margins. Ovo Energy [also] told [the CMA] that 3% was a fair margin ….
>
> "Actual EBIT margins are difficult to interpret due to customer acquisition costs and high growth. We consider that the target EBIT margins of 3% mentioned by some suppliers may indicate an aspirational margin for a supplier operating with an efficient level of capital employed and operating costs. A supplier who had not invested in systems to the same degree or had not achieved comparable efficiencies could not expect to realise the same level of profitability."

The CMA also found that using an appropriate return on capital employed approach and expressing this in terms of an appropriate EBIT margin suggests a figure of 1.3% is appropriate for the large UK energy providers.

Some respondents have highlighted that the CMA's review of the energy markets reported EBIT margins in the small and medium-sized enterprises (SME) business of the big six energy companies over the period 2009-10 to 2013-14 of 8.4%[23]. But the CMA's profitability analysis carried out in this review found that margins were too high. The CMA also reported the combined EBIT margin was lowest in the I&C markets at 2%. Our analysis of the 2014 consolidated segmental statements for the big six shows an aggregate EBIT margin in 2014 of 2.4%[24].

Both the PwC report and the CMA analysis encompassed benchmarks relevant to the independent operation of retail businesses.

None of the above suggests that a net margin 2.5% is inappropriate or inconsistent with the independent operation of a NHH retail business, and the evidence we have suggests a 2.5% net margin remains appropriate.

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[23] CMA Provisional findings report, 7 July 2015.
[24] Aggregate big six revenue of £16.8 million and aggregate EBIT margin of £0.4 million = 2.4%.

Net margin insufficient to encourage competition

Respondents to the consultation suggested that the net margin had not been set appropriately to encourage competition in the market. Bristol Water noted that the margin allowed would be before any discounts were applied and could therefore be too low for a default tariff cap, deterring entry and leading to lower long-term benefits. Business Stream suggested that there was uncertainty about the future market arrangements and that the margin should be increased to reflect these uncertainties.

We based the 2.5% net margin we set at PR14 on a range of considerations, including analysis by PwC, as summarised in the text box below.

Given the wide-ranging nature of PwC's assessment, we see no reason to consider that in overall terms a 2.5% net margin is too low. As we have already explained, the default tariff caps only cover existing tariffs – competitors may bring forward new tariffs, but any discounts reflected in these tariffs should be funded by efficiencies and new services such as water efficiency advice.

Thames Water also suggested that net margins should be set on a company-specific basis, and that this, therefore, reflects its relatively low wholesale charges. Given that the net margin funds working capital requirements that relate directly to the level of the overall bill, we are not convinced that this additional complexity would be appropriate or necessary.

Water retail net margins: a report prepared by PwC[25]

In carrying out its analysis, PwC considered data taken from regulatory determinations from:

- WICS;
- the Office of Gas Supply (Ofgas);
- the Commission for Energy Regulation (CER);
- the Utility Regulator (UREGNI); and
- the Office of Electricity Regulation (Offer).

They also considered actual margins from the big six energy companies, as well as:

- water retailing in Scotland;
- mobile telecoms retailing;

[25] 'Water retail net margins, A report prepared for Ofwat', PwC, February 2014.

- train operators; and
- postal retail operations.

PwC determined that for HH margins regulatory benchmarks (taken from low-risk monopoly suppliers) provided a better guide to suitable net margins for HH retail water companies as they relate to determinations with little or no competition. By comparing other regulatory determinations, PwC found that a net margin in the range of 0.5% to 2.0% for HHs (and NHHs in Wales) was sufficient. It also noted that it would expect the appropriate margins to be at the lower end of this scale because, in comparison to the benchmarks, this segment of the market has:

- simpler retailing processes;
- less price volatility;
- lower political risk; and
- fewer requirements to discharge environmental and social obligations.

For NHHs, PwC determined that margins should be higher than the margins it had identified for the HH sector and based more closely on benchmarks from competitive markets. However, its analysis also suggested that an appropriate retail net margin should be below 3.2% – the average level for Business Stream, the one NHH comparator that it had – given the considerable difference between water trading in Scotland and England (including the more favourable working capital arrangements in England).

For the lower end of the NHH range, PwC started with the low end of segmented benchmarks, but adjusted downward for differences between water and energy retailing, while keeping it above the low end of the HH margin range. It noted that this suggests a figure of around 1.0%.

Using a return on capital approach, which considered both the capital requirements and the cost of capital, PwC also determined a minimum margin of 0.6% for NHH activity. However, it recognised that its analysis was likely to omit some retail specific risks, which suggested that NHH margins should be set above 2.5% and not at the bottom end of the benchmark range.

Net margin insufficient to attract new entry

A number of respondents were concerned that a 2.5% net margin would be too low to attract new entrants into the market.

There are already signs of new entry. For example, Portsmouth Water has announced that from 1 April 2016 Castle Water will provide NHH retail services on its behalf, with the intention that Castle Water will compete in the market from April 2017. Severn Trent and United Utilities have also agreed to combine their NHH retail activities with the intention of capturing synergies and being more effective in the competitive market from April 2017. And we note that a number of WaSCs are competing in the Scottish market – and that part of the strategic rationale for these activities is preparation for the introduction of competition in England.

Credit costs and working capital requirements

A number of respondents to our consultation suggested that we should reflect changes to retailer–wholesaler payment terms in credit costs and working capital requirements that are funded from the net margin.

We set out details of the payment agreement terms between retailers and wholesalers in an information notice IN 13/21[26] to provide guidance to companies ahead of the submission of PR14 business plans. Subsequent changes were made to this in the market architecture plan (MAP) and further discussion on the options for retailers to deal with changes to payment terms are currently under way[27]. This has led to the formation of a number of different options for payment terms between retailers and wholesalers.

The current set of options that are being discussed employ two distinct forms of payment – pre-payment and payment in arrears. Under the pre-payment option, the wholesaler would have no additional credit risk, whereas for payment in arrears risk would be mitigated by a requirement for the retailer to provide a form of credit assurance. The complete list of options are as follows.

- Option 1: pre-payment.
- Option 2: payment in arrears + cash deposit (Escrow account).
- Option 3: payment in arrears + insurance.
- Option 4: payment in arrears + letter of credit.
- Option 5: Payment in Arrears + Guarantee.
- Option 6: payment in arrears + unsecured credit.

At PR14, we based a margin of 2.5%, in part, on consideration of the results of two sets of analyses set out in a recent PwC report (see text box above). This analysis suggested, using benchmarking, that an appropriate NHH retail net margin should be

[26] IN 13/21, 'Payment terms between wholesalers and retailers'. The payment terms assumed here were that retailers would pay wholesalers "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" and the retailer would need 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.
[27] We held a workshop, facilitated by KPMG and titled 'Credit terms between market participants' on this topic on 19 February 2016.

below 3.2% but above 1%. PwC's analysis also found the need for a 0.4% net margin[28] to cover the costs of NHH retailer's working capital requirements.

Considering the six options outlined above, we estimate the increase in net margin requirement to cover working capital and credit costs is 0.35% under the pre-payment option. We also note that the credit costs associated with insurance and letters of credit are more likely to be more costly than pre-payment. And we note that for the unsecured credit option, an overall reduction in the net margin by 0.27% would be appropriate.

As retailers are able to select the option that is most favourable to them, we expect that the most expensive options will only be used by a sub-set of retailers entering the market – and not by entrants able to lever on economies of scope with other activities (and so offer cash deposits or appropriate guarantees) and established retailers and incumbents. Any additional costs may also be temporary as credit history is achieved.

This suggests that there should be no general increase in credit costs and there is no compelling case to increase the allowed net margin of 2.5%.

In its response to our consultation, Business Stream noted that under the credit terms assumed at PR14 there would be a 15-day financing gap for retailers. It also implied that as consumers pay on a quarterly basis and retailers on a monthly basis, retailers would have an additional credit requirement.

We have reviewed the assumptions and allowances that we made when setting retail net margins at PR14.

- On working capital, funding for 45 days[29] was accounted for, exceeding the 15 days that Business Stream highlighted.

- On debtor and creditor days, actual numbers for debtor and creditor days faced by companies were used. Therefore, assuming no change to how retailers handle customer bills when competition opens, the average number of debtor days should remain unchanged (43 days).

[28] Total capital employed (£333m) x short term borrowing rate (3.2%) / Total allowed revenue (£2,671m) = 0.4%.
[29] Working capital days are calculated by £333 million/£2,671 million multiplied by 365 = 45 days.

Conclusions

We have not found any compelling evidence that suggests we should revise the overall NHH retail net margin of 2.5% allowed at PR14. In particular:

- evidence cited by the CMA in its investigation of the energy sector appears to support a net margin in the range 1% to 3%;
- we based the net margin of 2.5% on a range of evidence, including PwC's study, and the analysis remains valid;
- there is evidence of interest in the NHH retail market in England both by incumbents and potential entrants; and
- recent developments in credit costs and working capital requirements are consistent with a net margin of 2.5%.

Consultation question

Q2 We welcome views on our assessment of net margins and the initial conclusion that a 2.5% net margin remains appropriate.

3.2 Simplifying the default tariff price caps

The default tariff caps set at PR14 reflected the specific charging tariff structures of each company. We did not seek to impose a common set of national tariff caps consistent with each company's ownership of its business plan and its structure of charges. This approach also minimised the possible incidence effects on prices for different customer groups.

However, the variation in tariff structures across companies has created a degree of complexity in the default tariff caps. Differences in how companies have approached allocating their costs and margins to individual tariffs has reduced transparency and consistency, making comparability across companies difficult. We recognised this complexity in our consultation, where we illustrated the large differences in gross margins (that is, retail costs and margins as a percentage of wholesale costs) between companies for providing retail services to apparently similar customers.

Recognising this complexity, our consultation suggested that there could be benefits in encouraging companies to make proposals to improve:

- the transparency in how they map tariffs to default tariff caps; and
- comparability between companies' default tariff caps.

Most incumbent companies that responded to our consultation expressed reservations about measures requiring consistency, but their concerns appear to revolve around underlying tariff structures rather than default tariff caps. Other stakeholders were concerned with the lack of transparency and consistency in the present arrangements.

Our review focuses on the default tariff caps rather than underlying charging tariff structures. We agree with those respondents that suggested it would be disproportionate to change tariffs as part of this review, which are – in any case – subject to separate regulatory arrangements and processes. We intend to consult separately on wholesale charging, including on the scope for tariff simplification, later in 2016.

However, we consider that some simplification of the default tariff caps may be beneficial. In particular, there may be benefits in developing arrangements that are simpler and more consistent for those larger customers that should be best able to take advantage of the opportunities that a competitive market provides. Such simplification could:

- increase the transparency in company arrangements and therefore provide a modest boost to competition;
- help move the focus of the review from the allocations of costs/margins on individual default tariff caps to more important issues relating to customer protection and encouraging competition (such as making sure that the overall allowance level of costs/margins are appropriate); and
- help avoid any incentive on companies to make proposals for reallocating costs/margins between default tariff caps in a way that could skew cost recovery and limit competition.

A possible approach to simplifying the default tariff caps could involve changing the form of the control so that retail charges to larger customers are controlled using uniform caps on gross margins as a percentage of wholesale charges for incumbent companies. We illustrate this approach below, together with estimates of the gross margins deriving from the existing default tariff cap arrangements.

Tables 1, 2 and 3 below illustrate the customer segments that may be appropriate when applying the uniform cap on gross margins by service type.

Table 1: Metered water – PR14 retail gross margin as % of wholesale charge (WaSCs)

<table>
<tr><th>Volume band Ml per annum</th><th>ANH</th><th>NES</th><th>NWT</th><th>SRN</th><th>SVT</th><th>SWT</th><th>TMS</th><th>WSH</th><th>WSX</th><th>YKY</th></tr>
<tr><td>0 to 0.5</td><td>13.0%</td><td rowspan="3">7.9%</td><td rowspan="3"></td><td rowspan="3">22.2%</td><td rowspan="3"></td><td rowspan="3"></td><td>20.1%</td><td rowspan="3"></td><td rowspan="3">10.6%</td><td rowspan="3"></td></tr>
<tr><td>0.5 to 0.75</td><td rowspan="2"></td><td rowspan="2">10.4%</td></tr>
<tr><td>0.75 to 1</td></tr>
<tr><td>1 to 2</td><td rowspan="3">6.0%</td><td rowspan="6"></td><td rowspan="8">7.7%</td><td rowspan="3">6.4%</td><td rowspan="4">10.6%</td><td rowspan="8">5.3%</td><td rowspan="3">5.1%</td><td rowspan="8">6.7%</td><td rowspan="3">2.7%</td><td rowspan="8">6.8%</td></tr>
<tr><td>2 to 4</td></tr>
<tr><td>4 to 5</td></tr>
<tr><td>5 to 10</td><td>7.9%</td><td rowspan="3">5.1%</td><td rowspan="3">3.5%</td><td rowspan="4">2.4%</td></tr>
<tr><td>10 to 15</td><td rowspan="3">4.8%</td><td rowspan="4">1.9%</td></tr>
<tr><td>15 to 20</td></tr>
<tr><td>20 to 25</td><td rowspan="2">3.8%</td><td rowspan="2">2.8%</td><td rowspan="2">3.0%</td></tr>
<tr><td>25 to 50</td><td></td><td>1.7%</td></tr>
<tr><td>50 to 100</td><td rowspan="8">1.3%</td><td rowspan="3">3.6%</td><td rowspan="8">4.4%</td><td></td><td rowspan="8">1.6%</td><td>2.6%</td><td rowspan="4">2.8%</td><td>4.9%</td><td>1.8%</td><td rowspan="4">1.4%</td></tr>
<tr><td>100 to 150</td><td rowspan="7">1.2%</td><td rowspan="3">2.4%</td><td rowspan="3">4.8%</td><td rowspan="3">1.2%</td></tr>
<tr><td>150 to 175</td></tr>
<tr><td>175 to 250</td><td rowspan="5">1.3%</td></tr>
<tr><td>250 to 350</td><td rowspan="4">2.3%</td><td rowspan="4">2.8%</td><td rowspan="2">4.7%</td><td rowspan="2">1.0%</td><td rowspan="4">1.3%</td></tr>
<tr><td>350 to 500</td></tr>
<tr><td>500 to 1000</td><td>4.7%</td><td rowspan="2">0.8%</td></tr>
<tr><td>> 1000</td><td>4.6%</td></tr>
</table>

Key:

ANH = Anglian Water; NES = Northumbrian Water; NWT = United Utilities; SRN = Southern Water; SVT = Severn Trent Water; SWT = South West Water; TMS = Thames Water; WSH = Dŵr Cymru; WSX = Wessex Water; YKY = Yorkshire Water.

Table 2: Metered water – PR14 retail gross margin as % of wholesale charge (WoCs)

<table>
<tr><th>Volume band Ml per annum</th><th>AFW</th><th>BRL</th><th>DVW</th><th>PRT</th><th>SBW</th><th>SES</th><th>SEW</th><th>SST</th><th>CAM</th></tr>
<tr><td>0 to 0.5</td><td rowspan="19">8.9%</td><td rowspan="3">16.0%</td><td rowspan="11">6.2%</td><td rowspan="7">8.3%</td><td rowspan="2">18.2%</td><td rowspan="7">7.9%</td><td rowspan="6">10.4%</td><td rowspan="11">14.0%</td><td rowspan="13">8.2%</td></tr>
<tr><td>0.5 to 0.75</td></tr>
<tr><td>0.75 to 1</td><td></td></tr>
<tr><td>1 to 2</td><td rowspan="3">3.6%</td><td>3.5%</td></tr>
<tr><td>2 to 4</td><td>5.4%</td></tr>
<tr><td>4 to 5</td><td rowspan="2">6.9%</td></tr>
<tr><td>5 to 10</td><td rowspan="2">4.4%</td><td>3.1%</td></tr>
<tr><td>10 to 15</td><td rowspan="4">3.2%</td><td rowspan="4">5.0%</td><td rowspan="4">5.5%</td><td rowspan="4">2.7%</td></tr>
<tr><td>15 to 20</td><td rowspan="3">4.0%</td></tr>
<tr><td>20 to 25</td></tr>
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<tr><td>50 to 100</td><td>3.0%</td><td rowspan="4">2.6%</td><td rowspan="8">2.6%</td><td rowspan="8">2.7%</td><td rowspan="8">3.1%</td><td rowspan="4">2.5%</td><td rowspan="5">2.7%</td></tr>
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<tr><td>500 to 1000</td></tr>
<tr><td>> 1000</td></tr>
</table>

Key:

AFW = Affinity Water; BRL = Bristol Water; DVW = Dee Valley Water; PRT = Portsmouth Water; SBW = Bournemouth Water; SES = Sutton and East Surrey Water; SEW = South East Water; SST = South Staffs Water; CAM = Cambridge Water.

Table 3: Metered wastewater – PR14 retail gross margin as % of wholesale charge (WaSCs)

<table>
<tr><th>Volume band Ml per annum</th><th>ANH</th><th>NES</th><th>NWT</th><th>SRN</th><th>SVT</th><th>SWT</th><th>TMS</th><th>WSH</th><th>WSX</th><th>YKY</th></tr>
<tr><td>0 to 0.5</td><td>9.6%</td><td rowspan="11">4.7%</td><td rowspan="11">4.4%</td><td rowspan="3">11.3%</td><td rowspan="11">6.8%</td><td rowspan="11">4.1%</td><td>23.8%</td><td rowspan="12">5.2%</td><td rowspan="3">9.9%</td><td rowspan="11">6.4%</td></tr>
<tr><td>0.5 to 0.75</td><td rowspan="5">3.5%</td><td rowspan="2">10.4%</td></tr>
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<tr><td>100 to 150</td><td rowspan="7">1.0%</td><td rowspan="3">2.4%</td><td rowspan="7">2.4%</td><td rowspan="3">1.9%</td></tr>
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<tr><td>250 to 350</td><td rowspan="4">1.5%</td><td rowspan="4">2.1%</td><td rowspan="4">3.4%</td><td rowspan="2">1.6%</td><td rowspan="4">1.3%</td></tr>
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The main characteristics of this approach could include:

- uniform caps on the NHH retail gross margins applying to larger sites, differentiated into two bands (for instance reflecting water consumption of 1 Ml[30] to 50 Ml and 50 Ml and more); and
- bespoke default caps for sites using less than 1 Ml of water a year, either as caps on gross margins or in line with the existing structure with allowances for costs and net margins.

The uniform caps described above could also be applied to the default tariff caps applying to wastewater, trade effluent and surface drainage charges.

Other considerations would include the following.

- How best to calibrate the caps for larger customers – it would be important to not unduly constrain the charges to customers where competition is likely to be most vigorous.

- The focus of these arrangements would be to simplify the default tariff caps while minimising any impact on underlying tariffs. The structure of tariffs and tariff setting would remain the companies' responsibility.

- Companies would retain responsibility for complying with competition law when structuring and setting tariffs.

- Whether we would need to adjust the bespoke price caps in the circumstances where the new band was significantly above the default tariff caps. This could involve either a full or partial adjustment.

- Issues around the overall level of NHH retail costs and margins would be considered alongside simplification, but separate from it.

- Companies would have responsibility for managing any incidence effects associated with new price control arrangements.

[30] One megalitre (Ml) equals one million litres.

This approach would be simpler and more transparent (thereby helping competition) and would allow the price review to focus on issues such as the appropriate overall level of costs and margins rather than allocations to individual default tariff caps. However, there could be some risks to customers if companies did not manage any incidence effects, but with the development of competition, these are unlikely to be large.

Consultation questions

Q3 We welcome views on whether there are sufficient difficulties and complexities associated with the present arrangements to justify simplifying the form of the control by introducing uniform caps on the NHH gross margins for larger sites.

Q4 If we adopt such uniform caps, how should the level of gross margin be calibrated and what consequential adjustments should be made (if any) to the remaining default tariff caps that would apply to smaller sites?

If we decide there is insufficient justification for simplifying the form of control, we would need to consider how best to avoid any temptation on the part of incumbent companies to make proposals for reallocating costs/margins between default tariff caps in a way that could skew cost recovery and limit competition. Consistent with our approach to assessing the overall level of cost and margin allowances described earlier we could require that there was both:

- new and persuasive information on the appropriate cost and margin allocations to individual default tariff caps compared with that provided at PR14; and
- strong evidence that the existing allocations are flawed and will lead to a detriment to competition (and so the interests of customers).

Consultation question

Q5 If we do not proceed with simplifying the form of control, we welcome views on how we could ensure appropriate allocation of costs and margins and prevent any inappropriate reallocation of costs and margins to individual default tariff caps. In particular, whether we should require compelling evidence that both supports revised allocations and shows that the existing allocations would act as a detriment to competition, before accepting any revised allocations of costs and/or margins?

Eligibility to participate in NHH retail market

We based our PR14 final determinations around a definition of HH and NHH premises used in our old June return reporting requirements. We have since carried out further work on this, and issued guidance on eligibility in August 2015. More recently, we issued supplementary guidance to clarify a number of residual eligibility concerns.

The combination of our guidance and companies reviewing the information in their billing and customer databases means that there will be changes in the number of customers eligible to participate in the competitive market compared with the assumptions made at PR14. One company has indicated that its PR14 estimate of NHH customers may over-estimate the numbers now deemed to be eligible by as much as 20%.

Information received from other companies suggests that while there will be changes in the eligibility of some premises/properties, they expect relatively modest changes in the total number of customers eligible for competition.

Each of the HH and NHH retail price controls automatically adjusts total revenues for changes in customer numbers. However, our PR14 final determinations tied the definition of HH and NHH customers used to allocate customers between these controls to the regulatory accounting guidelines (RAGs). The RAGs presently use the HH and NHH definitions in place at PR14. So to use the automatic adjustment mechanisms in the price controls to deal with these issues we would need to update the definition of eligible customers used in the RAGs.

An alternative option would be to leave HH customers in the NHH control, but reduce the allowed margin on these customers to the 1% allowed for HH customers. However, to ensure that all NHH customers were allocated to the NHH control, we would need to change the eligibility definition. Bearing this in mind, it would seem most appropriate to simply change the definition of eligibility as set out in the RAGs.

Consultation question

Q6 How we should deal with differences between our PR14 final determinations and the present eligibility criteria in respect of categorising HH and NHH customers (that is, which customers will be able to participate in the competitive market)? In particular, whether we should change the definitions of HH and NHH customers in the RAGs (with effect from April 2017) so allowing the automatic adjustment mechanisms within the existing HH and NHH price controls to adjust revenues for these changes in customer numbers?

3.3 Duration of the next NHH retail price controls

In our consultation, we highlighted a number of options about the appropriate duration of the next NHH price controls, including whether we should set a shorter control of two years, a three-year price control, or a longer price control from 2017.

Our preferred approach was to set a three-year control to align with the existing controls for wholesale and household retail (which will end on 31 March 2020). This would allow us to:

- see how competition was developing in the NHH retail market; and
- deal with any further cost allocation issues that might emerge between retail and wholesale and/or NHH and HH retail.

There was strong support across all stakeholders for a three-year duration for the new price controls. Given this strong level of support for our proposal and the underlying logic summarised above, **we propose a three-year duration for the next NHH retail price controls.**

4. Process

This chapter deals with process – including next steps and timetable, information and other requirements, and the standard data tables incumbent companies will be required to complete and assure as part of this review.

4.1 Next steps and timetable

In our consultation, we provided an indicative timetable for this review that envisaged publishing:

- a statement of method in April 2016;
- draft determinations in September 2016; and
- final determinations in December 2016.

Most respondents considered this timetable to be too tight, with insufficient time for companies to prepare business information and complete data tables, and take account of audited information from 2015-16 before being required to provide information for this review. Potential market entrants and some incumbent companies also indicated that final determinations should be brought forward to allow better information ahead of market opening in April 2017.

To the extent it is practicable, we would like to respond to the above concerns. As well as publishing this draft statement of method in March rather than April, we have moved back the date by which companies need to provide data tables until later in July so companies can better take into account audited information from 2015-16. However, we need a reasonable process of consultation and engagement to set price controls, which includes time to formulate and publish both draft and final determinations. Bearing these important obligations in mind, we do not regard it as practicable to bring forward final determinations. We have reflected these considerations and proposals in the revised timetable set out in table 4 below.

Table 4: Timetable for the 2016 NHH retail price control review

Date	Milestone
19 April 2016	Companies respond to Ofwat draft statement on method and data table requirements for the review.
19 May 2016	Ofwat confirms statement on method and data table requirements for the review.
20 July 2016	Companies submit any changes to their cost and margin allocations together with the data tables and supporting evidence. These should be consistent with audited 2015-16 regulatory accounts and regulatory reports.
15 September 2016	Ofwat publishes draft determinations.
28 October 2016	Companies and stakeholders respond to the draft determinations.
15 December 2016	Ofwat publishes final determinations.
April 2017	New non-housed retail price controls and charges come into effect and the retail market opens.

4.2 Provision of information and other requirements

Our consultation highlighted that companies would be responsible for:

- publishing evidence that they were engaging with their customers on a continual basis and that from this engagement, and their day-to-day interactions with customers, they had gained support for any proposed changes to their default tariff caps or decisions to leave their default tariff caps unchanged;
- publishing evidence that demonstrated, in overall terms, that any changes would be revenue neutral and consistent with the principle that the focus of our review is on reallocating costs and margins between tariffs rather than the overall level of the gross margin for NHH retail; and
- publishing a Board assurance statement on compliance with all their legal obligations.

We also sought views on what further information (if any) companies should be required to provide and publish, and the potential benefits of requiring companies to publish information showing:

- the allocation and attribution of costs and margins to the default tariff caps are reasonable and robust; and
- any proposals they make for default tariff caps (including proposals for no change) are consistent with competition law.

Respondents had mixed views on what information should be provided and published as part of this review. For example, incumbent companies indicated, in general, that information requirements should be proportional to the scope of the review and its impact on customers. However, a number of potential market entrants considered that significantly more information should be provided and made publicly available, but they did not address how commercially sensitive information should be dealt with or offer to make available information on their own costs.

Consistent with the focus of this review being on price caps rather than charging arrangements, our view remains that companies should deal with issues relating to compliance with competition law when setting charges. Therefore, we do not intend to introduce requirements for third party assurance in respect of compliance with competition law.

However, companies should be prepared to provide and make publically available information and evidence that supports their allocations of costs to individual default tariff caps. Given that the default tariff caps relate only to the existing tariff structures and that the cost allowances were based on historical costs, we do not consider that this would present an overwhelming difficulty in terms of commercial sensitivity of information.

If companies make proposals for changes to default tariff caps that would change tariffs and have significant incidence effects on customers then we would expect these to be supported by evidence from companies' ongoing customer engagement and research and their day-to-day interactions have with customers. We would also expect that companies would have engaged with their customer challenge groups (CCGs) on these matters. Companies will also retain responsibility for ongoing customer engagement and research in respect of tariff setting and responsibility for managing any incidence effects.

Consistent with what we said in our consultation, it will be important for each incumbent company to provide a Board assurance statement on the business plan information they provide as part of this review. This will need to provide assurances that:

- the information they provide is consistent with their legal obligations (including, where relevant, the prohibitions on undue discrimination or preference in licence condition E, the licence condition R and the charging scheme issued by Ofwat[31] under section 143B of the Water Industry Act 1991) and competition law;
- their proposals have been reasonably informed by customer engagement, and research and discussion with their CCG – in particular, where there are proposals for changes to default tariffs that will change tariffs and have incidence effects;
- the allocation and attribution of costs and margins to the default tariff caps are reasonable and robust (with costs and margins attributed by appropriate drivers and activities, and the proportion of costs subject to broader allocation rules kept to the minimum that is reasonably practicable); and
- data tables have been completed accurately and consistent with any guidance that we have provided.

Consultation question

Q7 We welcome views on whether the following approach to the provision of information by incumbent companies as part of this review is appropriate:

- companies retain ownership of tariff setting and compliance with competition law and so we will not require third party assurance on these matters;
- companies will need to justify and provide and publish evidence supporting their allocations of historical costs to their default tariff caps and showing why any revised allocations would not be a detriment to competition;
- if companies are making proposals for changes to default tariff caps that would change tariffs and have significant incidence effect these will need to be supported by customer engagement; and
- all companies will be required to provide a Board assurance statement in relation to the meeting of their legal obligations, customer engagement and that information on cost allocations and attributions and other data is reasonable and robust.

[31] 'Consultation on charges scheme rules for 2016-17 and future developments', Ofwat, September 2015.

4.3 Data tables

Incumbent companies will be required to complete and assure standard data tables if they are seeking to rebalance the allocations of costs and margins between default tariff caps. This will help us to calibrate our draft and final determinations of revised NHH retail price controls.

To promote efficient working, consistency and the timely completion of the data tables we have adapted and simplified tables that companies completed as part of the PR14 process. In particular, we have simplified data table R4 – the revised version will request less information on each default tariff price cap with the requirement for each of the three years from 2017-18 being limited to:

- tariff name;
- tariff categorisation;
- number of customers;
- net margin;
- retail cost per customer; and
- allocated wholesale charge.

The table will be pre-populated for each company with the information adopted at our PR14 final determinations (or in the case of Bristol Water, with the figures determined by the CMA). Companies will then have the option to override the pre-populated figures with their revised allocations of costs and margins, and also the ability to change the structure of their default tariff caps. Companies wishing to retain their existing allocations will not need to make changes to the table, but will be required to provide Board assurance and evidence that supports this approach.

The input table will be supplied as part of a spreadsheet model including calculations designed to quantify the impact of changes to the aggregate retail costs and margins. Our intention is that this will provide a common understanding of proposed impacts and identify the requirement for additional supporting information. We seek to minimise the query process following business plan submission.

These tables will form our baseline information request. Companies will be required to provide further information and evidence alongside these tables, as discussed in section 4.2 above.

For further detail of the data tables, please refer to the Excel spreadsheets published alongside this document and available on our website.

We will also hold workshops on 14 and 15 April to provide companies with an opportunity to comment on the details of the data tables.

Appendix 1: Summary of responses

This appendix provides a high-level summary information of the responses to our consultation on the review of NHH retail price controls. Specifically, it summaries the responses we received to the questions that we raised in our consultation, which covered:

- the scope of the review;
- the level of costs and margins available;
- the transparency of mapping tariffs to default tariff price caps;
- the diversity of default tariff price caps and information requirements;
- the scope to not update margins and cost allocations;
- the duration of the next price controls; and
- our proposed timetable.

A1.1 Scope of the review

Most of the incumbent water companies supported limiting the scope of our review to issues relating to NHH price controls/caps. In contrast, a number of other stakeholders – particularly potential market entrants – considered that the scope of our review should be broadened to allow for consideration of wider issues, such as the allocation of costs between wholesale and retail price controls.

Some of the incumbent companies questioned the legality of broadening the scope of our review to other controls, and cautioned about the potential impact on regulatory stability. However, Anglian Water highlighted increases in NHH retail costs since our 2014 final determinations and the low level of allowed margins. In these circumstances, it questioned whether we would be meeting our duty to ensure that companies are able to finance their functions and risk potential breaches of competition law, unless we broadened the scope of the review.

A1.2 Level of costs and margins

While a number of respondents expressed support for limiting the review to the re-allocation of costs/margins, not all of them commented explicitly on whether the level of aggregate costs and margins should be constrained. Many respondents considered that the aggregate level of cost and/or margin should be reviewed as a matter of course, including ten respondents that considered the aggregate levels of costs and/or margins were too low and should be increased.

Typically, they suggested either that insufficient costs had been allocated to NHH retail or that NHH costs were increasing in line with the new market requirements. Both Business Stream and Clear Business Water provided detailed evidence suggesting insufficient costs had been allocated to NHH retail activities and that there were significant inconsistencies in cost allocation across incumbent companies.

A1.3 Transparency of mapping of tariffs to price caps

Most respondents supported increased transparency and suggested ways to improve transparency. These suggestions typically included clear mapping between individual tariffs and each default tariff cap. Some respondents suggested that any mapping should also demonstrate how actual costs and margins comply with the average revenue control. Most of the incumbent companies that did not support increased transparency indicated that they already had clear mapping between tariffs and the default tariff caps.

A1.4 Diversity of default tariff price structures and cost/margin allocations

Most, but not all, incumbent companies expressed reservations about measures to require consistency, although some seemed to be more concerned about underlying tariff structures rather than default tariff caps. Other stakeholders generally supported more consistency.

A1.5 Information requirements

Incumbent companies generally indicated that information requirements should be proportional to the scope of the review. There was support for providing evidence to justify cost allocations, but there was limited support for any requirement for third party assurance. We received mixed views on whether evidence should be required to support proposals for no change.

Some potential market entrants thought that significantly more information should be provided and made public. But, in general, they did not address how potentially commercially sensitive information should be dealt with (given the transition from monopoly to market-based arrangements), or offer to make available information on their own costs.

A1.6 No updating of cost and margin attributions and allocation

Most incumbent companies supported our view that they should have the option of not updating their margin and cost allocations if they considered the existing allocations remained appropriate. Other stakeholder responses were more diverse, and a number of respondents suggested that there was sufficient evidence of flaws in the existing cost and margin allocations that it was unlikely that no change would be an appropriate option.

A.1.7 Duration of the control

There was strong support for a three-year duration for the next price controls.

A1.8 Proposed timetable

Most respondents considered our proposed timetable as too tight. However, potential market entrants and some incumbent companies suggested that final determinations should be brought forward to allow better information ahead of market opening in April 2017.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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