Default tariff design workshop

18 March 2014

Outline of session

10.00	Introduction and purpose	Andrew Beaver
10.05	Background and context	Andrew Beaver
10.20	Default tariff design issues	Tom Rogers
11.00	Coffee break	
11.15	Allocation of net margins	Tom Rogers
11.45	Allocation of costs	Tom Rogers
12.15	Next steps	Andrew Beaver
12.30	Close	

Purpose of workshop

To discuss design and cost allocation issues regarding non-household retail default tariffs

We will cover specifically:

Background to the issues
Issues surrounding the design of default tariffs
Issues surrounding the allocation of net margins to tariffs
Issues surrounding the allocation of costs to tariffs

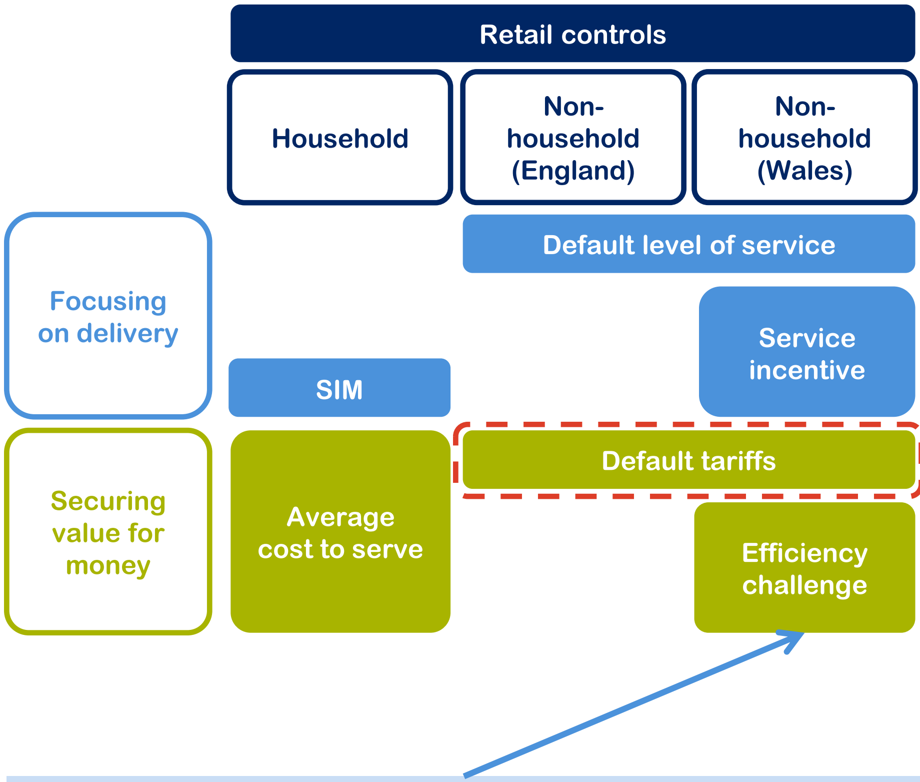
Alongside workshop materials we will publish:

The slides
A note of the meeting, including any relevant questions and answers

Background and context

Andrew Beaver, Director of Strategy

Role of default tariffs for non-household retail controls



Default tariffs

Safeguard protection for customers in England and promote competition

Non-household customers automatically put on default tariffs

Use GSS as the minimum level of service

Separate default tariff structure for each company

Set a gross margin (costs plus margins) per customer to deal with churn

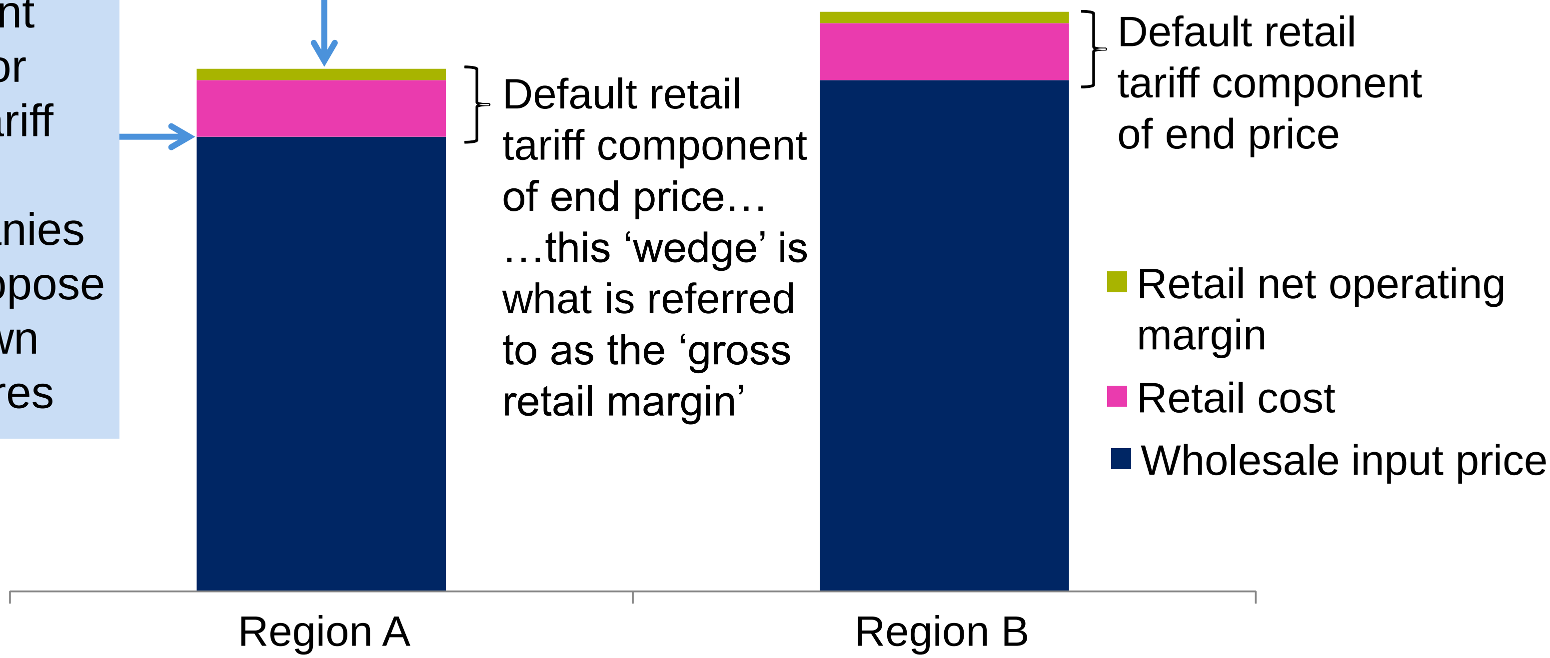
Wales

Where customers cannot choose in Wales we will continue to apply an efficiency challenge and service incentive to default tariffs

Constructing the default tariff

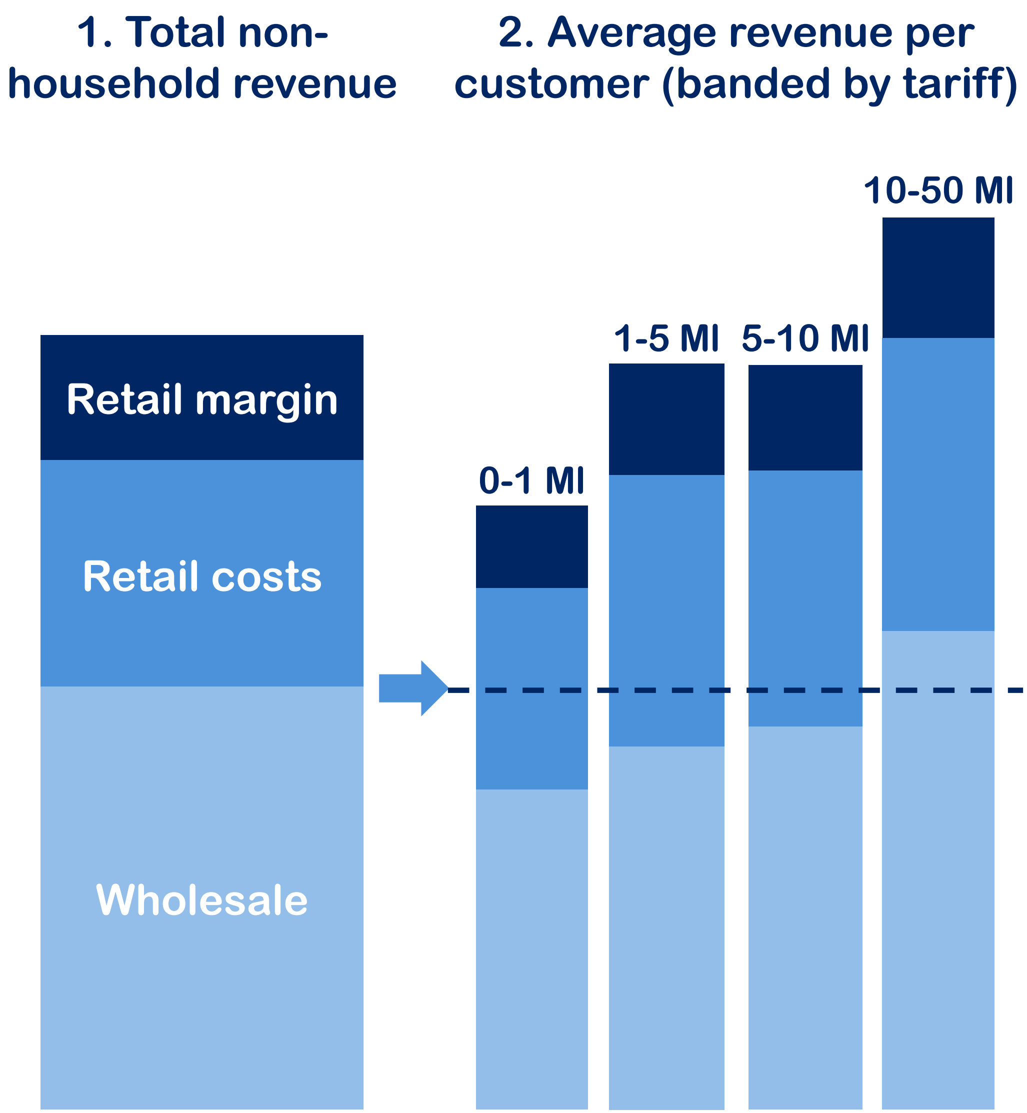
3. Apply a net margin

1. Relevant costs for each tariff band
2. Companies can propose their own structures



4. Propose simple national service level based on GSS
5. Set as an average revenue control to address customer churn issues
6. Customers are automatically migrated onto default ('opt out')
7. Propose service and efficiency incentives for Welsh customers who cannot choose

Default tariffs as an average revenue control per NHH customer



We are setting average revenue per customer by customer group. By customer group we mean tariff band. Companies can propose tariff bands with their default tariffs

Average revenue controls mean that if companies lose customers they will lose revenue

Company proposals for default tariffs

As part of the **business plan submissions**, companies submitted default tariffs

There were a number of **fundamental issues with submissions,** including:

- Calculation errors
- Tariffs with zero charges
- Tariffs with zero customer numbers
- Tariffs having a different number of charges than charging multipliers

In addition, companies used a **range of approaches to allocate costs**

Updated process for setting default tariffs

Given the errors and inconsistencies in business plan submissions, the decision was made to **remove the default tariffs from the risk-based review**

In January, we announced that we would instead run **an adapted process** to request further supporting information from companies by 1 March

On the basis of the information companies sent to us, **we plan to issue further guidance** on 4 April

Companies will then resubmit table R4 (default tariffs) with further supporting information by **15 May**

Consequently, **today's workshop is designed to reflect on the information sent to us by companies and the potential content of further guidance to be issued next month**

Default tariff design issues

Tom Rogers, Principal Analyst

Key default tariff design issues

Structure of charges/variables used

Dual service tariffs

Types of tariffs proposed

Developer services

Quality assurance

Structure of charges

Companies proposed a range of charging variables, methods of allocation between different variables, and in some cases new tariff bands

In our final methodology we stated that our preferred approach was to use companies' proposed structures, which we expected would likely be based on their existing tariff structures

However, we do **remind companies that new tariff structures can cause incidence effects**, and we would expect companies to undertake an impact assessment of any significant incidence effects, and to clearly justify why an alternative approach has been used

Dual service tariffs

Some WaSCs structured their tariffs as water-only, sewerage-only, and water and sewerage. Others only produced water tariffs and separate sewerage tariffs, while others reflected single/dual service variables within the tariffs. One company labelled all its tariffs ‘water and/or sewerage’

It is debatable whether scope economies need to be explicitly recognised in default tariffs at all, as default tariffs are intended to provide a ‘back-stop’, with companies being able to offer customers alternative tariffs if they so wish

However, placing a de facto restriction on dual service discounts being offered as part of the default tariffs would unlikely be in the interests of customers

Dual service tariffs

We are currently minded to set the requirement for: a tariff for water-only, a separate tariff for sewerage-only, and for where WaSCs considered that it would be appropriate to reflect economies of scope in the default tariff (as opposed to through other means), to include a variable (that is, a discount) within each relevant tariff to reflect the scope economies

Consequently, if a customer was to change retailer for one service, they would be able to remain on the default tariff for the other service, but would lose the dual tariff discount

Types of tariffs

Some WaSCs did not propose a trade effluent default tariff

The revenue for trade effluent is currently separated out in companies accounts. It has some fairly distinct features from general sewerage retailing and so it would seem appropriate to have a separate default tariff for trade effluent

We are currently minded to require WaSCs to propose trade effluent default tariffs

Types of tariffs

Minded to proposals:

Water only companies (WoCs) will need to provide a minimum of two default tariffs for retail non-household customers in their appointed areas:

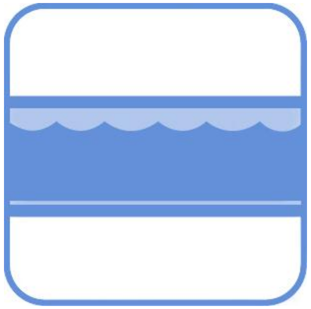
- Measured water
- Unmeasured water

Water and sewerage companies (WaSCs) will need to provide a minimum of five default tariffs for retail non-household customers in their appointed areas:

- Measured water
- Unmeasured water
- Measured sewage
- Unmeasured sewage
- Trade effluent

Companies operating wholly/mainly in Wales will need to provide separate sets of default tariffs for customers above and below the 50 Ml threshold

Developer services



Some companies excluded developer services from R4, while others allocated the costs associated with developers across their default tariffs

Including developer services’ costs in deriving the default tariffs would lead to double-recovery

Therefore we are minded to amend R4 so that developer services costs are explicitly removed and not to set default tariffs for developer services

Quality assurance

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

For the 15 May submission, we expect companies to apply appropriate quality checks to assure themselves as to the quality of their submissions, and are minded to require companies to supply a statement explaining how they have assured themselves that the revised information, tables and underlying data submitted are of high quality

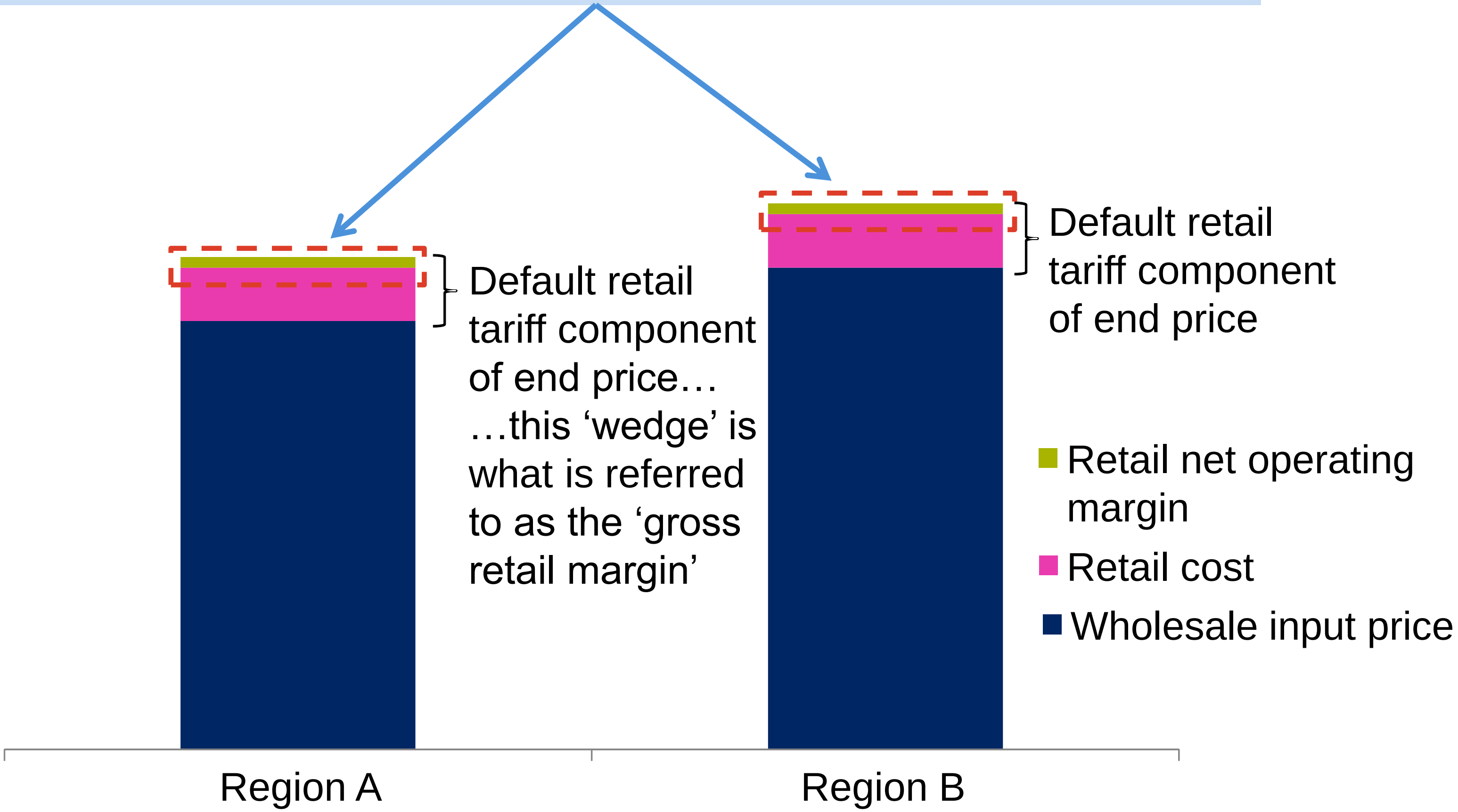
Coffee break

Allocation of net margins

Tom Rogers, Principal Analyst

Net margin as a component of default tariffs

As described earlier, along with retail costs, the **retail net operating margin** forms part of the default tariff for non-household customers, or the 'gross retail margin' (cost + margin)



Net margins – company submissions

A number of companies submitted R4 tables that **did not include the net margin** within the proposed charges

Some companies had **incorrectly applied the net margin**

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

Many companies in their business plan submissions **did not consider applying different margins to different tariff bands**

Many companies in their business plan submissions **did not consider having different margins for their proposed default tariffs in different years of the control period**

Net margins – proposed way forward

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

On aggregate over AMP6, **we expect default tariffs in total to have a net margin of 2.5% over expected wholesale charges and relevant retail costs, or 1.0% for customers using less than 50 Ml** served by companies that are wholly or mainly operating in Wales

We expect companies to consider whether it would be appropriate to have **different net margins for different default tariffs**, as there may be different relevant finance costs and risks associated with different customer types

At an absolute minimum, net margins need to cover the working capital required

Net margins – proposed way forward

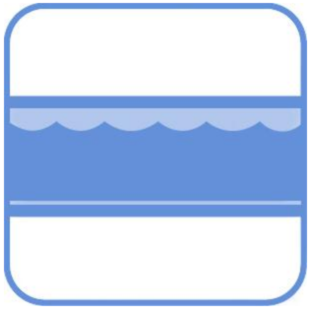
We suggest that companies should further **consider whether a variation in margin for proposed default tariffs across different years would be appropriate** given the expected retail non-household market environment in the next price control period

For example, an argument could be made that for the first two years of AMP6 the risk of supplying non-household retail services will be broadly equivalent to those of household retail services as the retail market does not open until April 2017, and companies have important risk mitigants available in the non-household market (for example, some more flexibility to vary price and service offers to meet customer requirements, and the ability to disconnect for non-payment)

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

Simplified example where retail and wholesale costs are forecast to be constant

Wholesale charges



In populating table R4, companies need to provide proposed wholesale charge levels for each tariff band

We would generally expect companies to broadly deduct the retail component from existing charges (adjusting for forecast changes in levels) in order to forecast wholesale charges

Where companies have deviated from this approach (to ensure that wholesale charges are more cost reflective, given the different nature of the services concerned, for example), we would expect companies to undertake an impact assessment of any significant incidence effects, and to clearly justify why an alternative approach has been used

Allocation of costs

Tom Rogers, Principal Analyst

Cost allocation

To deliver a robust and consistent approach to cost allocation, we included a retail test focused on cost allocation as part of the PR14 risk based review process.

However, companies' business plans displayed a general lack of sufficient information to allow us to test cost allocation consistently, and so we issued an information request seeking additional information on the approach companies took to allocating costs across their business.

The responses to the information request revealed that some companies had used the cost drivers we had set out in our guidance while others had not.

Consequently, we will be issuing more detailed guidance for cost allocation between retail/wholesale, and household/non-household. This has a clear read-across for default tariffs.

Cost allocation

Companies also used a range of approaches to allocate costs between tariff bands. Not all the drivers used to allocate costs were particularly cost reflective.

We are minded to set out a set of proposed drivers (consistent with the control-level guidance) that we expect companies to use to allocate costs between tariff bands, unless they can demonstrate that the drivers they have used are more cost reflective.

Wherever possible, companies should be looking to directly attribute costs rather than making top-down allocations.

Cost allocation

Cost type	Cost driver
Billing	Number of bills raised
Payment handling, remittance and cash handling	Number of payments received
Non-network customer enquiries and complaints	In order of preference 1) Time spent on non-network customer enquiries and complaints 2) Volume of non-network customer enquiries and complaints
Network customer enquiries and complaints	In order of preference 1) Time spent on network customer enquiries and complaints 2) Volume of network customer enquiries and complaints
Other customer services	In order of preference 1) Appropriate cost driver (based on nature of cost) or where there isn't an obvious cost driver 2) customer numbers
Debt management	Debt outstanding for more than 30 days (i.e. not current debt)
Customer doubtful debts	Directly attributable on a customer specific basis
Meter reading	In order of preference 1) Time (based on timesheets) 2) Number of meter reads factored by scheduling an allowance for average time taken 3) Number of meter reads

Cost allocation

Cost type	Cost driver
Disconnections and reconnections	Directly attributable on a customer specific basis
Demand-side water efficiency initiatives	Direct allocation where initiatives are specific to household or non-household, otherwise customer numbers
Customer-side leaks	Directly attributable on a job specific basis
Other direct costs	In order of preference 1) Time (based on timesheets) 2) Another more appropriate cost driver (depending on nature of cost) or where time basis isn't possible and there isn't an obvious cost driver 3) customer numbers
I.T., motor vehicles, Finance, HR, payroll, executive team, general management, facilities/building grounds maintenance, insurance costs, local authority rates, cumulo rates	Customer numbers
Other general and support and other business activities (regulation)	In order of preference 1) Appropriate cost driver (based on nature of cost) or where there isn't an obvious cost driver 2) customer numbers

Next steps

Andrew Beaver, Director of Strategy

Next steps

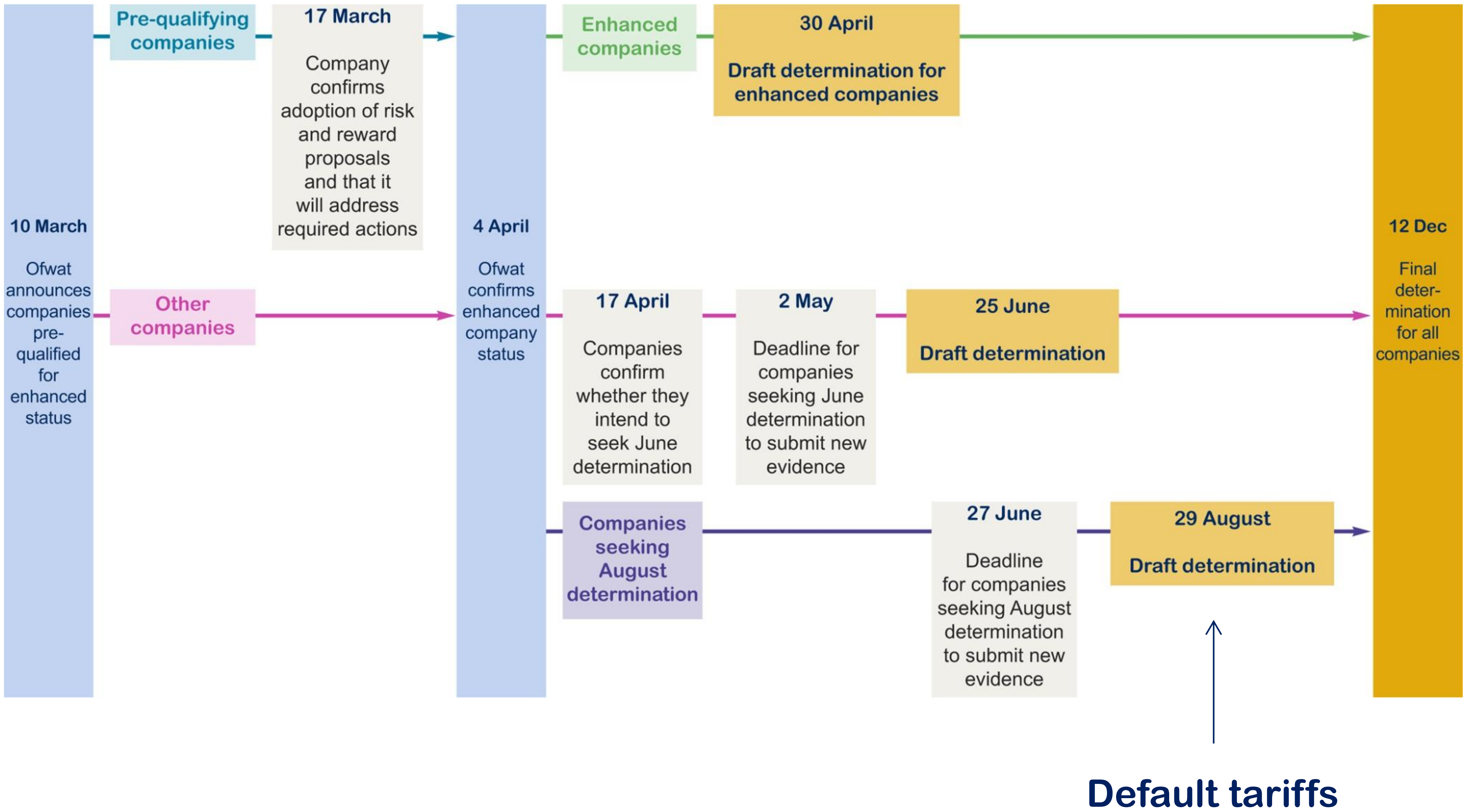
Ofwat to publish updated guidance on 4 April regarding how companies should submit R4 data tables

Companies to submit table R4 data tables and all supporting information by 15 May 2014

Ofwat to run a short query process to clarify any unexpected or unsubstantiated data following the May submission

Ofwat to produce draft determinations for default tariffs in line with the timeline for August draft determinations (that is, 29 August 2014)

Next steps



10 March
Ofwat announces companies pre-qualified for enhanced status
Pre-qualifying companies
17 March
Company confirms adoption of risk and reward proposals and that it will address required actions
Other companies
4 April
Ofwat confirms enhanced company status
Enhanced companies
30 April
Draft determination for enhanced companies
17 April
Companies confirm whether they intend to seek June determination
2 May
Deadline for companies seeking June determination to submit new evidence
25 June
Draft determination
Companies seeking August determination
27 June
Deadline for companies seeking August determination to submit new evidence
29 August
Draft determination
12 Dec
Final deter-mination for all companies
Default tariffs