Preparing business plans for the 2014 price review – retail questions and answers

14 November 2013

In 2014-15, we will decide the price and service package (the 'price controls') that each of the monopoly water and sewerage and water only companies in England and Wales must deliver in each of the five years between 2015 and 2020. As part of the 2014 price review process (PR14) the companies are now preparing their business plans, which will set out their proposals for the next five years. They will submit these to us by 2 December 2013.

In 'IN 13/07: 2014 price review communications between Ofwat and water companies', we set out our approach for engaging with water companies and other key stakeholders during the 2014 price review. As of 1 October the price review has entered the restricted communication phase. During this phase Ofwat will only respond to business plan queries if we feel it is appropriate. If this is the case then we will make our responses to these queries available to all companies.

We have so far published three question and answer documents to clarify the business plan reporting requirements. The first was released on 23 September, the second on 18 October and the third on 25 October.

This fourth question and answer document presents further queries and answers specifically about the retail controls. These were raised by companies following the retail workshop and were therefore received by Ofwat during the restricted phase of communications. We are therefore sharing our response for the benefit of all companies.

We set out the questions raised and our responses below.

Retail – special agreements

Q1. On table W8 and S8 the company must provide information relating to special agreements (whereby charges are pre-agreed by contract, and not variable until the contract is re-negotiated) – however, it is less clear (in conjunction with table R4) if it is expected that any retail costs associated with special agreements are to be reflected in the non-household retail average revenue control, or if special agreements are to be treated as wholesale only charges. Can Ofwat please clarify?

Companies should include special agreements in their business plans in the following way.

- Special agreements for non-household customers should be split between a retail charge – set as a default tariff (in table R4) – and a wholesale charge, in the same way as other charges for non-household customers are treated.

- The retail default tariffs proposed for non-household special agreements must be compliant with competition law. They should allow an 'as efficient entrant' to enter the market for the provision of the special agreement.

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

- The retail costs of serving households with special agreements should be included in the household retail table (table R3).

- Only the wholesale element of the charges should be included in the wholesale tables for special agreements (tables W8 and S8).

Retail – wholesale income

Q2. Is all the wholesale income received from the retail business? Our specific query is in respect of rechargeable income and costs relating to damages to apparatus. In our accounting separation tables this is wholesale (treated water distribution cost). It has a bad debt element, which has been charged to retail. Should this all be wholesale (costs including the bad debt charge), and should the income be in the wholesale part of the business too?

If the wholesaler tries to recover costs of damage to its network from a third party that does not pay, the bad debt cost should be attributed to wholesale, with no costs allocated to retail. The retail business should not bear the risk of bad debt for rechargeable works. The income received should also be attributed to the wholesale part of the business.

Retail – developer services

Q3. Should development services be allocated to household or non-household retail? Does it depend on whether the development is household or non-household? What about mixed developments? Alternatively, should the allocation be based on whether the developer is an individual or a business?

Developer services, in terms of managing developer queries and providing information to developers, should all be allocated to non-household, irrespective of whether the development is household, non-household or mixed. This is true whether the developer is an individual or a business.

Retail and wholesale cost allocation

Q4. RAG 4.04 definitions: We note the prescriptive approach to allocating costs to retail; however, this will lead to inconsistencies between the regulatory accounts and business plan submissions. Should historical costs be restated for this prescribed approach to allocating G&S and regulatory costs?

This question is answered in the note from the workshop on retail issues.

Historic costs should be restated using the approach prescribed for allocating G&S and regulatory costs in the note of the retail price control workshop held on 26 September.

> **"Ofwat has subsequently clarified that for the purpose of preparing business plans, we confirm that basis must be the number of FTE employees engaged in wholesale versus retail activities according to the definitions in the methodology statement, unless the costs are directly attributable either to regulated wholesale or regulated retail services.**
>
> **"For general and support costs, examples of 'directly attributable' costs could include the costs of a dedicated finance manager for the retail business or insurance premiums which relate only to the retail business, where no apportionment or proxy is required to attribute the costs between wholesale and retail.**
>
> **"Within retail, an example of 'directly attributable' costs would be the costs of a customer services team which only deals with non-household customers, the costs of which could be allocated directly to retail non-household services.**

Where an apportionment or proxy is required, such as the number of household/non-household contacts, the allocation should be made based on the number of household and non-household customers."

Retail – outcomes

Q5. For table R1, are we correct in assuming that all retail capex should be shown as 'incremental expenditure in relation to retail operating expenditure and depreciation of retail assets'? That is, the total in line 9 will include all retail capex but not retail opex.

Any expenditure, whether it is capex or opex, required to deliver a level of service improvement compared with that funded under the average cost to serve (ACTS) should be included in the outcomes table. We are drawing no distinction between capex and opex in this table.

Retail – price bases

Q6. Tables R3 and R4 are to be completed in 2012-13 prices but we are not sure what this means for presenting our base retail operating expenditure.

Because RPI does not automatically apply to retail, do we assume that our numbers will appear flat both in real and nominal terms, before any input price pressures? Or do we deflate the costs by RPI to give constant 2012-13 prices?

In table R3 Household ACTS control, company input price pressures are to be entered into line 13 for household in table R3. So, if we do assume that the costs appear flat, if you then add line 1 to line 13 you will get our view of the nominal costs in that business unit, which can then be used in your financial model, which works in nominal terms.

Companies' numbers should be flat in both real and nominal terms before any input price pressures (that is, inflation is zero). It is correct that any retail household input price pressures should be entered into line 13 of table R3. Our starting assumption is that no adjustments need to be made for input cost pressures. If companies consider they will need to make adjustments, these should be fully evidenced.

If companies consider they are likely to change their approach to retailing during the period (for example, through outsourcing or insourcing) and they expect this to change the mix of capex and opex in their retail costs, then they should reflect this in lines 1 and 3 of table R3, again excluding input price pressures, which should be entered into line 13 of table R3.

Retail margins

Q7. The note of the retail price control workshop held on 26 September clarifies how a retail margin % should be applied when calculating the retail allowed revenues. At the workshop, the use of an average retail margin and a glidepath was mentioned. Please can you confirm if this is to be the case? And if so, how will this work and how (if at all) will this affect our business plan submission?

It is for companies to propose their retail margins in their business plans. In the note of the retail price control workshop held on 26 September, we set out how companies should go about doing so. We will review companies' proposals as part of the risk-based review.

Retail – competition costs

Q8. We understand that Ofwat has advised companies to include estimates of the costs of introducing competition for non-households into their business plan assumptions.

Is it possible for you to give guidance or clarification of the approach we should take to allocation of the potential costs expected to be incurred through the introduction of retail non-household competition. These costs will include those attributable to the Open Water programme and those incurred in adapting our retail and wholesale IT systems to interface with Central Market Agency software to enable customer switching and account resolution.

How costs of the market operator and Open Water should be accounted for is explained in a letter sent from Sonia Brown to water company CEOs on 28 October.

Other costs of competition should be included in companies' business plans and allocated to the wholesale controls.

Retail – ACTS and depreciation

Q9. In Ofwat's list of queries published on 23 September, question 27 referred to current cost depreciation in relation to the ACTS and table R3. For depreciation in table R3 lines 2 and 3 the guidelines say it should be on a historical, IFRS basis. Please can you clarify the approach to depreciation?

This question is answered in the note of the retail price control workshop held on 26 September.

"Ofwat clarified that for the purposes of business planning tables and setting the 'average cost to serve' (ACTS) depreciation should be provided on a historic cost basis for tangible and intangible (that is, billing system software) assets.

"In addition, companies are asked to state in their commentary whether their depreciation would be different if reported on a current cost basis (CCD) as it has been historically. If it would be different, companies should also report their depreciation on a current cost basis in their commentary.

"Since costs have previously been accounted for on a CCD basis any historic comparisons made as part of the risk-based review of business plans would need to be made using CCD."

Retail – household revenue adjustments

Q10. Please can you provide a worked example of the household retail annual adjustment (explained in appendix 2, A2.8) and how it will work in conjunction with the revenue correction mechanism explained in chapter 2?

We are particularly interested in understanding the following:

- Appendix 2, A2.8 states that the annual adjustment will begin in 2016-17 (adjusting for differences in 2015-16). However, tariffs are set in January of each year, so the 2016-17 tariffs would have already been set (in January 2016) before the final numbers for 2015-16 are known. Therefore, would there effectively be a 2-year lag to the annual adjustment?
- While the annual adjustment will provide a mechanism to adjust allowed revenue for historic (known) differences, will allowed revenue also be recalculated each year for anticipated differences (for example, revised estimates of customer numbers)? For example, if customer numbers were higher than expected in 2015-16 then we would adjust allowed revenue for this 2015-16 difference in 2016-17, but should we also be adjusting the 2016-17 revenue based on higher customer numbers than were initially estimated in the business plan?
- Given that there is a lag in applying the annual adjustment, what will happen in 2020-21? Will all the adjustments be taken care of through RCM? Or will there be an annual adjustment for 2019-20 made in 2020-21 to adjust allowed revenue based on customer numbers, in addition to the RCM?

Companies' business plans should contain their best current estimates. In section 2.3 of the methodology statement we confirmed that there will be a revenue correction mechanism to allow for the difference between predicted retail revenue and actuals. We will confirm the details of this revenue correction mechanism in the final determination.

Retail workshop – example calculations

Q11. Generic queries on the worked examples we set out in tables 1 and 2 of the note of the retail price control workshop held on 26 September that either asked for clarification or highlighted potential errors.

Table 1

The total metering expenditure in table 1 on page 7 should be 4, not 2.

We confirm that the modification for future depreciation is calculated once only in 2013-14. This is then used to calculate the cost to serve (CTS) for the purposes of calculating the ACTS.

We have reviewed the calculation of the allowed CTS for companies who are above the ACTS and we agree that the modification for future depreciation should also include residual depreciation for assets included in the RCV (forecast depreciation during AMP6). So, the modification should be calculated as:

> (Average AMP6 Total operating expenditure (excluding exceptional items) + average AMP6 Total depreciation of assets that are not included in RCV (AMP6 or later assets) + average AMP6 Total depreciation of assets included in RCV (assets existing before AMP6)) – (2013-14 Total operating expenditure (excluding exceptional items) + 2013-14 Total depreciation of assets that are not included in RCV (AMP6 or later assets))

We have set out a reworked table 1 in appendix 1 of this document (see page 9).

Table 2

We confirm that the text on page 10 of the meeting note is correct – we said that companies whose CTS was below the ACTS would be allowed the top three retail cost lines from slide 22 of the workshop slides (that is, the companies' forecast total operating expenditure, depreciation of assets included in the RCV and depreciation of assets not included in the RCV).

In appendix 1, we have corrected the numerical example from the meeting note (see page 11).

Appendix 1 Updated tables for the note of the retail price control workshop held on 26 September

The tables below replace those set out on pages 7–8 and 11 of the note of the retail price control workshop held on 26 September. The numbers in red signify a change from the original publication.

Table 1 Numerical example – how allowed revenue would be calculated for a company above the ACTS

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Operating expenditure (£m)	18	18	18	18	18	18
Depreciation in RCV (£m)	2	1	0.5	0	0	0
Allowed depreciation not in RCV (£m)	0	2	2.5	3	3	3
Modification for future depreciation (£m)	1					
Total costs (£m)	21					
Customer numbers (millions)	1					
CTS (£ per customer)	21					
ACTS (£ per customer)	19.8					
Efficiency challenge (£ per customer)	1.2	0.3	0.6	0.9	1.2	1.2
Allowed CTS (£ per customer) (before adjustments, incl legacy depreciation)		20.7	20.4	20.1	19.80	19.80

Allowed CTS (£ per customer) after removing legacy depreciation per customer		19.7	19.9	20.1	19.80	19.80
Allowed company specific adjustment (£ per customer)		2	2	2	2	2
Allowed recoverable costs £ per unmeasured customer		21.7	21.9	22.1	21.80	21.80
Total retail metering expenditure – water only customers (£m)	4					
Customer numbers (millions)	10					
CTS (£ per customer)	0.4					
ACTS (£ per customer)	0.5					
Efficiency challenge	0	0	0	0	0	0
Additional allowed recoverable costs per measured water only customer		0.4	0.4	0.4	0.4	0.4
Allowed recoverable costs per unmeasured customer		21.475	21.75	22.025	21.8	21.8
Allowed recoverable costs per measured water only customer		21.875	22.15	22.425	22.2	22.2

Table 2 Numerical example – how allowed revenue would be calculated for a company below the ACTS

	2013-14	2015-16	2016-17	2017-18	2018-19	2019-20
Operating expenditure (£m)	15	15	15	15	16	15
Depreciation in RCV (£m)	2	1	0.5	0	0	0
Allowed depreciation not in RCV (£m)	0	0	0.5	1	1.5	1.5
Modification for future depreciation (£m)	0					
Total costs (£m)	17					
Customer numbers (millions)	1					
CTS (£ per customer)	17					
ACTS (£ per customer)	19.8					
Efficiency challenge (£ per customer)	0	0	0	0	0	0
Allowed CTS (£ per customer) (before adjustments, incl legacy depreciation)		16.00	16.00	16.00	17.50	16.50
Allowed company specific adjustment (£ per customer)		0	0	0	0	0
Allowed recoverable costs (£ per unmeasured customer)		15.00	15.50	16.00	17.50	16.50