September 2016

Trust in water

Business retail price review 2016 (PR16): draft determinations

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About this document

From April 2017, 1.2 million businesses, charities and public sector organisations ("businesses") that are customers of water companies operating wholly or mainly in England will be able to choose their supplier of water and wastewater retail services. Businesses that are customers of companies operating wholly or mainly in Wales will be able to choose their retailer for water (but not wastewater services) if their premises are supplied with at least 50 mega litres (Ml) of water per year.

As competition develops business customers who are eligible to switch should be able to change retailer to ensure that they receive the package of prices and retail services that best suits their circumstances. But in the transitional period, until competition becomes effective, business customers may need additional protections and so we are setting revised business retail price controls to provide back-stop protection for business customers and complement the development of competition. Continuing price control protection will also be needed for those customers of companies operating wholly or mainly in Wales, who will not be able to choose their retailer in a competitive market.

We published consultation papers on this price review in November 2015 and March 2016 and our statement of method in May 2016. This document sets out **draft determinations for business retail price controls** for the three year period immediately after market opening (April 2017). Our draft determinations for those companies operating wholly or mainly in Wales differ in certain respects from those operating wholly or mainly in England, reflecting the differences in the competitive arrangements between England and Wales.

These draft determinations are based on our assessment of whether the evidence provided by each company in support of its proposals for default tariff caps for customers using less than 5 mega litres (Ml) has met the requirements set out in our statement of method. We have also developed simpler backstop price controls to protect larger customers (that should be best able to take advantage of the competitive market) consistent with the approach described in our statement of method.

Responses to this consultation are due by **28 October 2016**. We intend to publish final determinations on 15 December 2016.

Contents

1. Overview

Introduction

In 2014, the UK Government put in place legislation to enable eligible customers[1] to switch water and wastewater retailer. For customers supplied by companies operating wholly or mainly in England those eligible will include all business customers, but for companies operating wholly or main in Wales only those customers using more than 50Ml of water per year will be eligible, reflecting the different policy position of the Welsh Government.

Eligible customers will be 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.

After market opening there is likely to be a transitional period before competition is fully effective and customers may benefit from additional protection during this time. In light of these considerations our December 2014 price review (PR14) final determinations set business retail price controls. The two-year duration for these price controls took into account representations from water companies (including those operating wholly or mainly in Wales) that there would be advantages in reviewing these arrangements before the English market opens in April 2017.

In May 2016, following consultation with stakeholders, we issued our statement of method that outlined our approach to assessing company proposals and setting the new price controls that will operate for business retail services[2] between 1 April 2017 and 31 March 2019 (PR16). Our approach is designed to ensure that the price controls will not create undue barriers to entry or expansion, or restrict the ability of

[1] Information on eligibility is available through our Eligibility guidance on whether non-household customers in England and Wales are eligible to switch their retailer and Supplementary guidance on whether non-household customers in England and Wales are eligible to switch their retailer.
[2] Business retail services refers to non-household retail services as defined in appointee licences.

customers to secure deals with retailers that best meet their needs, while providing an appropriate level of backstop protection for customers.

This document sets out our draft PR16 price controls for the 17 water and sewerage and water only companies in England and Wales for the three year period starting from April 2017.[3] In making these decisions we have recognised that the Welsh Government has decided that the scope of retail competition in Wales will remain at current levels, so businesses, charities and public sector organisations in Wales will be able to choose their retailer of water (but not wastewater services) only if their premises are supplied with at least 50Ml of water a year.

The business retail price controls

At PR14 we set price controls (default tariff caps) for business retail. 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. These caps protect customers for the two years ahead of market opening, and provide back-stop protection and a comparison point for customers once the market opens. Default tariff caps cover only existing tariff structures. They will not apply to any new tariffs that emerge with the development of competition.

The default tariff caps were based on projections of:

- an allowance for business retail costs;
- the charges for wholesale services, which are collected by business retailers on behalf of the wholesaler (necessary so we could calculate retail margins); and
- a retail net margin to provide for the efficient financing of capital employed in providing business retail 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 business retail costs on 2013-14 costs, with some adjustments following the PR14 review process. Each company then took the lead in allocating business retail costs and net margins to individual default tariff caps. This form of price control created some complexity, with more than 250 default tariff caps.

[3] There will be separate controls for the South West and Bournemouth areas, although these two companies merged in 2015.

Assessing company proposals for changes to their default tariff caps

In making these draft determinations we have applied the approach we set out in our statement of method, with the main considerations summarised below.

- To protect smaller customers that may be less able, at least initially, to take advantage of the competitive market (and those customers of companies operating wholly or mainly in Wales not able to participate in the competitive market) from unnecessary price rises companies would need to provide substantial new evidence to support claims for any increases in the overall net margin of 2.5% (1% for non-contestable customers of companies operating wholly or mainly in Wales) or increases in the overall level of cost allowances made at PR14.
- As well as increases in the overall level of costs, the statement of method explained that it would be important to protect smaller customers (that may be less able to take advantage of the competitive market) from any inappropriate rebalancing of cost/margin allocations between default tariff caps. Companies proposing to increase prices to smaller customers would need to satisfy a high evidential bar, including providing:
  - evidence from their ongoing customer engagement and research, and their day-to-day interactions with customers, supporting any price increases
  - evidence of engagement with and support from their Customer Challenge Groups (CCGs)
  - where appropriate third party assurance and other evidence.

- If a company's Board was satisfied that modest changes in estimates of eligible customer numbers would have no substantial impact on its cost/margin allocations then it could provide assurance on this basis and it would not need to submit proposals for revised default tariff caps to reflect inconsequential changes.

Companies were also asked to provide a Board Assurance Statement as part of their proposals, including confirmation that:

- the information they provide is consistent with their legal obligations and competition law;
- where appropriate their proposals have been reasonably informed by customer engagement, research and discussions with their CCG;
- either the original allocations and attributions that informed the PR14 final determinations remain reasonable or that the allocation and attribution of costs and margins to revised or new 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.

The intention behind these requirements was to encourage companies to provide high quality information and ensure that any changes to the price controls were consistent with the interests of customers. In particular that increases in cost/margin allowances or rebalancing of charges by significantly reducing prices to larger customers (typically best able to take advantage of a competitive market) and increasing prices to smaller customers would be clearly supported by strong and convincing evidence.

Simplifying default tariff caps

As set out in our statement of method our approach to PR16 also involves simplifying default tariff caps for larger customers (that should be most able to take advantage of competition) to help ensure a proportionate approach to regulation that focuses on back-stop protection where competition is likely to be vigorous. We consider this will bring benefits to customers in terms of:

- a better, more targeted and proportional regulation that provides a more transparent approach to protecting the interests of customers;
- moving the focus of this price review away from re-allocating costs/margins between tariff caps and emphasising the importance of back-stop protection for customers;
- customers will be protected by the back-stop protection provided by the uniform bands and the supplementary limit on price increases;
- emphasising the responsibility of companies to manage their obligations under competition law and avoid pricing behaviour that might be regarded as a margin squeeze;
- further encouraging the development of competition in the business retail market; and
- better managing the transition to competition while continuing to provide back-stop protection to customers in relation to the delivery of water retail services.

The implementation of arrangements for simplification will reflect the different competitive arrangements applying to the customers of companies operating wholly mainly in Wales, with simplification only applying to the price caps for customers using more than 50Ml of water per year.

Summary of the results of our assessment and analysis

Our statement of method explained that we would simplify the price control arrangements for larger customers and focus the price controls on backstop protection for those customers most able to take advantage of the competitive market. The advantages of this approach are summarised above and the proposals set out in detail in chapter 3.

For smaller customers (those using less than 5Ml per year), the emphasis was to make sure that any additional overall allowances for costs/margins proposed by companies were justified by substantial new evidence and that there was a high evidential bar for any rebalancing of cost/margin allocations that would increase prices for smaller customers. We have assessed each company's proposals on this basis and accepted those where the level of assurance and evidence provided by the company is commensurate with the level of change it has proposed. More details on the results of our assessment provided in chapters 2 and 4 and appendix 2, with a brief summary set out below.

The following companies proposed making no or very limited changes to their PR14 caps and we intend to accept these proposals as the basis for the new default tariff caps:

- Bristol Water;
- Dee Valley Water;
- Portsmouth Water; and
- South West Water.

The following companies proposed making minor changes to their PR14 caps and our assessment was that the evidence that they provided with their proposals was of at least reasonable quality and proportionate to the minor changes being proposed. In the light of these factors we intend to accept these proposals as the basis for the new default tariff caps:

- Affinity Water;
- South East Water;
- South Staffs;
- Southern Water; and
- Sutton and East Surrey Water.

Yorkshire Water also appear to be proposing minor changes but we will require further information to confirm our understanding of its proposals. If it is able to provide satisfactory information then we will accept its proposals as the basis for the default tariff caps that will apply for the period 2017/18 to 2019/2020. Otherwise we will need to consider further regulatory intervention to protect the interests of customers.

The following companies proposed making more significant changes to their PR14 caps and we intend to accept these proposals as the basis for the new default tariff caps as they were supported by strong and comprehensive evidence that was proportionate to the bill impacts of the proposals:

- Severn Trent Water;
- United Utilities; and
- Wessex Water.

South West Water also suggested more significant changes to the PR14 caps applying in the Bournemouth Water area. We have made a modification to these proposals and used the modified caps as a basis for these draft determinations.

Four companies made proposals that were not supported by evidence that was sufficiently convincing, comprehensive and/or robust:

- Anglian Water;
- Dŵr Cymru;
- Northumbrian Water; and
- Thames Water.

For these companies we have retained the PR14 price caps that apply to customers using less than 5Ml. They (along with other stakeholders) can make further representations to us by the 28 October and we will consider these in formulating final determinations (to be published on 15 December).

Document structure

This document is structured as follows:

- Chapter 2 outlines our consideration of company proposals on the overall level of cost to serve, margins and eligibility issues;
- Chapter 3 outlines our approach to simplifying the form of control for PR16, including how we have set the level of uniform back-stop protection;
- Chapter 4 outlines our overall assessment of company proposals; and
- Chapter 5 outlines our next steps.

Appendix 1 contains our draft notifications for the business retail price controls for all the companies (these are drafts of notifications necessary as part of the legal process for implementing the revised price controls after final determinations and are likely to be of most interest to companies). Appendix 2 contains summaries of company specific proposals. Appendix 3 contains additional information on company proposals that we have considered in coming to our decision on the calibration of the uniform gross margin bands. Appendix 4 lists company acronyms that we have used for the figures in chapter 3.

Responding to our consultation

We invite responses to these draft determinations by **28 October 2016**.

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

PR16: Business retail price controls
Ofwat
21 Bloomsbury Street
London
WC1B 3HF

We will publish responses to these draft decisions on our website at www.ofwat.gov.uk unless you indicate that you would like your response to remain unpublished. 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. Decisions on costs, margins and eligibility

This chapter outlines our draft determination decisions on:

- the overall allowances for business retail cost to serve (section 2.1);
- the overall allowances for business retail net margins (section 2.2); and
- how we will deal with changes in the numbers of customers eligible for the competitive market (section 2.3).

2.1 Cost to serve

In our statement of method we indicated that the evidence available suggested retaining the overall level of business retail cost allowances made at PR14. However, we also indicated that should substantial new evidence emerge that demonstrates that the existing cost to serve allowance is not in the best interests of customers, we would consider this in developing our draft determinations.

Two companies put forward arguments for reviewing the cost to serve allowances:

- Anglian Water has told us that retaining the aggregate retail cost allowances at the levels set at PR14 would create risks of failure to recover costs, which could be considered as anti-competitive predation and/or create a margin squeeze. It has suggested that the price control should allow for additional costs, including those associated with its new retail business model which Anglian estimated will be £11.9m in 2017/18, about 30% higher than those allowed at PR14 (£9.1m). It also noted that sector costs are now 28% higher than the costs allowed at PR14 and that its projection for 2017/18 that its costs will be 4.5% of revenue is in line with the sector average of 4.6% for 2015/16.
- Northumbrian Water stated its view that the UK vote to leave the EU creates new inflationary risks to retail costs and that this should be reviewed as part of PR16.
- Both Anglian Water and Northumbrian Water considered that there is evidence in water supply and sewerage licence applications about the cost of operating separate arms' length retail businesses that should be reviewed as part of the PR16 process.

We have considered the evidence provided and note the following.

- Anglian Water's actual costs of £9.1m in 2015/16 were in line with the PR14 allowance of £9.1m for 2017/18 and we note that there is no evidence in Anglian's reported costs of substantial increases in overall cost levels. We also note that in 2015/16, eight out of ten water and sewerage companies had retail costs as a percentage of retail revenue (which also includes the recovery of

wholesale charges) below the 4.5% level that Anglian Water suggests is appropriate for its business retail activities. So rather than supporting its position the latest data suggests that the large majority of water companies that Anglian is most comparable to have reported cost levels below the levels Anglian claims is appropriate.
- Actual inflation for 2014/15 and 2015/16 has been significantly lower than the levels assumed at PR14 and no evidence has been presented by Northumbrian Water demonstrating that cumulative inflation is likely to be higher than assumed levels.
- It is not clear that the levels of the default tariff caps should be increased to provide additional funding for companies plans to restructure their businesses to compete across the wider market.

On balance we do not consider that the information provided meets the test of substantial new evidence that demonstrates it would be in the interests of customers (including in relation to facilitating competition) to make additional overall allowances for retail costs in setting the price controls. In formulating final determinations we will consider any further representations that we receive from stakeholders on these matters in response to this consultation.

2.2 Net margins

In the absence of compelling evidence for change we indicated in our statement of method our intention to retain our view that a net margin of 2.5% is appropriate for securing the efficient financing of capital employed in providing business retail services and reasonably remunerating risk – but we set out two areas that would merit further consideration.

- Credit terms and the consequential working capital requirements (which is only one component of the overall net margin) that have been under consideration as part of the retail market opening programme.
- The circumstances in Wales are different to those in England and that we need to consider this in making decisions on margins for those companies operating wholly or mainly in Wales (as they only face competition in relation to water business retail customers using more than 50Ml water per year and so do not require a competitive net margin of 2.5% across all of their customer base).

There were no claims from incumbent companies on the overall allowed level of net margin but separately Business Stream has continued to express concerns about the adequacy of the overall net margin, not least in relation to the working capital allowances implicit in the net margin. We recognised these issues in our statement of method where we noted that we would revisit these matter later in this review, once there was more clarity on the final proposals for the working capital arrangements that will apply after market opening.

Our statement of method noted that of the 2.5% net margin allowed at PR14 it was assumed that 0.4 percentage points would be needed to cover working capital and credit costs. The latest proposals on working capital and credit cover include a range of credit cover options, each with a range of costs – with a number of these having a range of costs significantly above the level of the 0.4% assumed at PR14. However, we assume that incumbent business retailers would seek to adopt the most cost effective option or options available, and that they would, in general, have access to finance on relatively favourable terms as they are a part of a business that would have access to investment grade credit ratings. We are also mindful that although we identified 0.4% as the cost of working capital and credit at PR14, the overall allowance of 2.5% was derived primarily from comparisons with other sectors. The evidence that we have seen from companies cost/margin allocation models suggests that allocations relating to return on capital, working capital/credit costs and risk do not account for the whole of the 2.5% margin and that there is remaining unallocated margin. Bearing these factors in mind suggests it is not necessary to increase the overall net margin allowance of 2.5%.

We have received no representations on the overall level of margins for companies operating wholly or mainly in Wales (Dŵr Cymru and Dee Valley Water) but Dŵr Cymru has made a proposal to smear the recovery of the competitive margin across its contestable and non-contestable customer bases. This issue is addressed further in chapter 4.

2.3 Changes in the number of eligible customers

Companies were provided the opportunity to put forward changes in their proposals including with respect to changes in the numbers of eligible customers. We also noted our statement of method that we would need to update the definition of eligible customers used in the Regulatory Accounting Guidelines to ensure that the automatic adjustment mechanisms that we built into the price controls at PR14 will function with an appropriate degree of flexibility.

Our statement of method explained that if a company Board were satisfied that there would be only modest changes in the estimates of the numbers of eligible customers compared to PR14 and that these changes would not have a substantial impact on its cost/margin allocations then it could provide us with assurance on this basis and it would not need to make revised proposals for default tariff caps to reflect inconsequential changes.

Seven companies were satisfied that their PR14 customer numbers remained appropriate and provided assurance on that basis. The remainder have proposed changes to the number of eligible customers, although this has varied in both absolute and percentage terms as shown in Table 2.1 below. For two companies, Severn Trent Water and United Utilities, changes to customer numbers primarily relate to the consolidation of multiple wastewater tariff bandings adopted at PR14 into the simplified structure at PR16.

Table 2.1: Companies proposing change in customer numbers

Company	Proposed customer numbers for 2017/18	Change vs PR14	Comments
Severn Trent Water	346,374	-40%	Not eligibility related
Sutton and East Surrey	11,940	-22%	
Wessex Water	109,135	-21%	
Bournemouth	14,161	-13%	
United Utilities	445,620	-11%	Not eligibility related
South East Water	52,119	-10%	
Dŵr Cymru	166,413	-5%	Not eligibility related
Northumbrian Water	148,101	-3%	
Thames Water	501,962	-2%	
Anglian Water	226,578	2%	
Southern Water	174,266	12%	

A small number of companies expressed concern that using the automatic adjustment mechanisms in the price controls might not be revenue neutral, but they did not provide any evidence suggesting that any asymmetries would be a material issue. We therefore continue to consider that the automatic adjustment mechanisms built into the price controls at PR14 should function with an appropriate degree of flexibility by allowing companies to recover retail costs and margins through the relevant business or residential control as appropriate.

Where companies have made significant changes to customer numbers in their data tables we have assessed whether the company proposals include appropriate adjustments to aggregate business retail costs to recognise that some of those costs may now be recovered though the residential retail control as a consequence of changes in eligibility. These matters are discussed further in chapter 4.

3. Simplification

This chapter sets issues relating to the simplification of the form of control:

- our rationale for simplification (section 3.1);
- the common structure adopted for larger (greater than 5Ml) customers (section 3.2);
- the calibration of the uniform gross margin controls which will apply to customers with volumes in excess of 5MI, including the treatment of companies operating wholly or mainly in Wales (section 3.3); and
- our proposals for the supplementary restraint which seeks to limit price increases where companies have headroom between their proposed allocations and the uniform gross margin controls (section 3.4).

3.1 Rationale

As noted in our statement of method we consider there are advantages in simplification of the price controls applying to larger customers (that will in general be best placed to take advantage of the competitive market), including:

- a better, more targeted and proportional regulation that provides a more transparent approach to protecting the interests of customers;
- moving the focus of this price review away from re-allocating costs/margins between tariff caps and emphasising the importance of back-stop protection for customers;
- customers will be protected by the back-stop protection provided by the uniform bands and the supplementary limit on price increases;
- emphasising the responsibility of companies to manage their obligations under competition law and avoid pricing behaviour that might be regarded as a margin squeeze;
- further encouraging the development of competition in the business retail market; and
- better managing the transition to competition while continuing to provide back-stop protection to customers in relation to the delivery of water retail services.

For the avoidance of doubt the proposals for simplification apply to the price controls and not the underlying tariffs – each company will retain the freedom to set tariffs for larger customers and be able to respond to its customers' needs, provided that it meets the overarching requirements of the price control and acts consistently with its other legal obligations (including those relating to competition law).

3.2 Common structure for default tariff caps

The common structure set out in the statement of method involves four uniform national price controls that will apply to all the tariffs for customers using more than 5 Ml per year for each company operating wholly or mainly in England.

Table 4.1: Common structure for default tariff caps

Volume (Ml per annum)	Water (includes mixed use and not potable water)	Wastewater (includes trade effluent and surface water drainage)
0 to 5	Company specific controls including unmeasured water	Company specific controls including unmeasured wastewater
5 to 50	Uniform back-stop control	Uniform back-stop control
Over 50	Uniform back-stop control	Uniform back-stop control

3.3 Calibration of the uniform back-stop protection

In our statement of method we said that gross margin bands would apply for customers using more than 5Ml and that 'it is intended that the uniform gross margin controls will be set to provide a level of back-stop protection for customers but not constraining a reasonable allocation of costs and margins'.

The intention was to simplify the form of the control and make it clear that for larger customers most able to switch retailer the control should be backstop protection. To achieve this we would set these uniform bands at a level that would not constrain the recovery of reasonable costs.

The statement of method included initial estimates of the gross margin bands – as summarised in the table below. Most companies did not make representations on these bands, but those that did emphasised that they should not constrain the recovery of reasonable costs. Following our review of the pattern of cost allocations provided by companies in their proposals, our assessment is that only minor changes to the indicative bands set out in our statement of method are necessary. This is summarised in Table 3.2 below, with more detail of our analysis set out in sections 3.3.1 to 3.3.4.

Table 3.2: Calibration of uniform gross margin controls

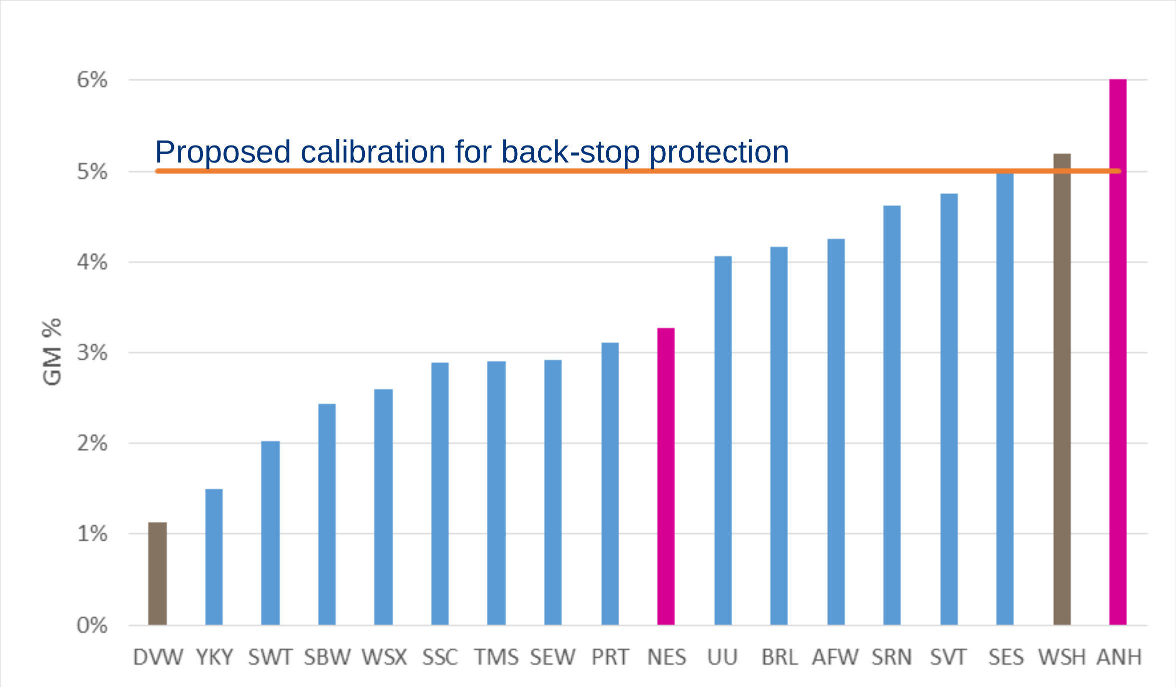
Volume (mega litres per annum)	Water (includes mixed use & non-potable water)		Wastewater (includes trade effluent & surface water drainage)	
	Indicative	Draft determination	Indicative	Draft determination
5 to 50	5%	**5.0%**	5%	**5.3%**
Over 50	3%	**3.3%**	3%	**2.8%**

3.3.1 Water 5 to 50 mega litres uniform back-stop protection

Company proposals for gross margins in 2017/18 are shown in Figure 3.1 (below). Their allocations of retail costs, net margins and wholesale charges result in gross margins ranging from 1.1% for Dee Valley Water to 8.5% for Anglian Water.

We have highlighted the Anglian Water and Northumbrian Water margins in red as we have concerns with the data they submitted with their proposals. Dee Valley Water and Dŵr Cymru are highlighted due to the special circumstances applying in Wales. The Welsh companies' gross margins relate to non-contestable customers in this volume band and so are excluded from the uniform gross margin proposals (as these customers will not be able to switch retailer to take advantage of lower prices).

Figure 3.1: Company proposals for Gross Margins (water 5 to 50 mega litres)



Note: the acronyms used in this and subsequent figures are explained in Appendix 4.

Excluding Anglian Water and Dŵr Cymru suggests a maximum cost reflective gross margin of 5% – as this would be consistent with the allocations of all other companies (including Sutton and East Surrey Water that has allocated costs and margins in a way that gives a 5% gross margin for 5 to 50Ml water customers). This cap will apply to all the companies operating wholly or mainly in England.

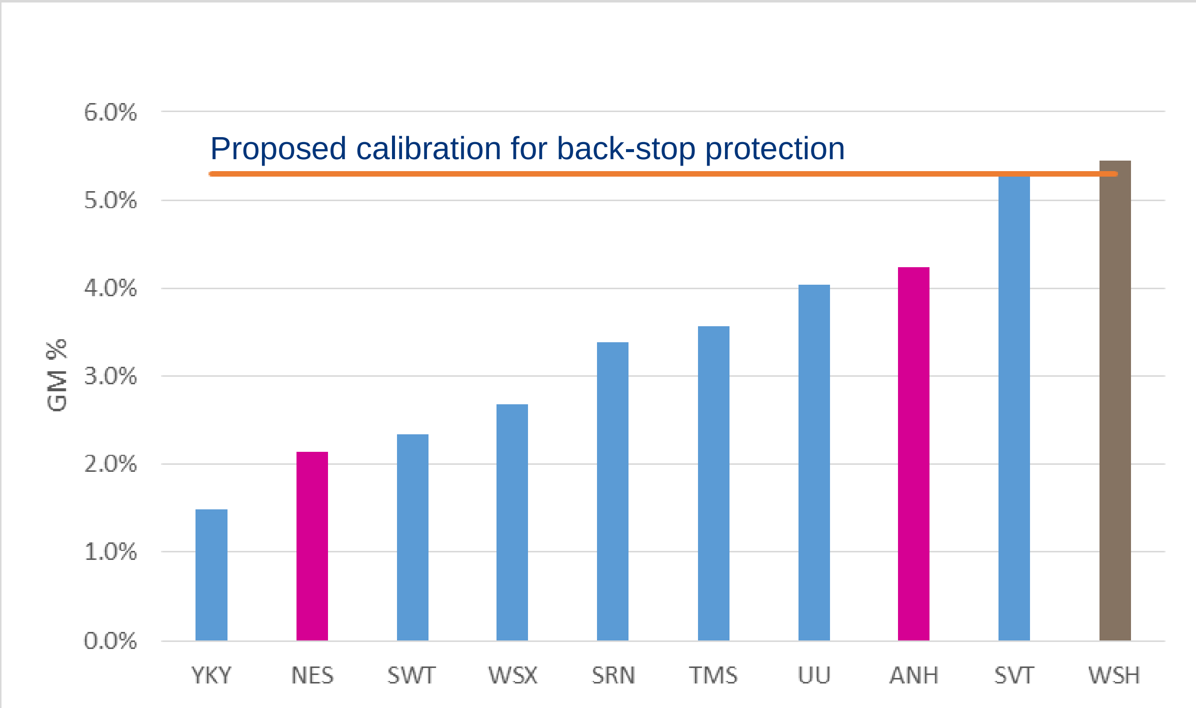
Additional information on the average retail costs and net margin allocations proposed by companies is available in Appendix 3.

3.3.2 Wastewater 5 to 50 mega litres uniform back-stop protection

Company proposals for gross margin in 2017/18 range from 1.5% for Yorkshire Water to 5.4% for Dŵr Cymru as shown in Figure 3.2 below.

Excluding Dŵr Cymru from this range, reflecting the special circumstances in Wales with no retail competition for these customers, suggests a maximum cost reflective gross margin of 5.3%. This is consistent with the allocations of all other companies (including Severn Trent Water that has allocated costs and margins in a way that gives a 5.3% gross margin for 5 to 50Ml wastewater customers). This cap will apply to all the companies operating wholly or mainly in England.

Figure 3.2: Company proposals for Gross Margins (wastewater 5 to 50 mega litres)



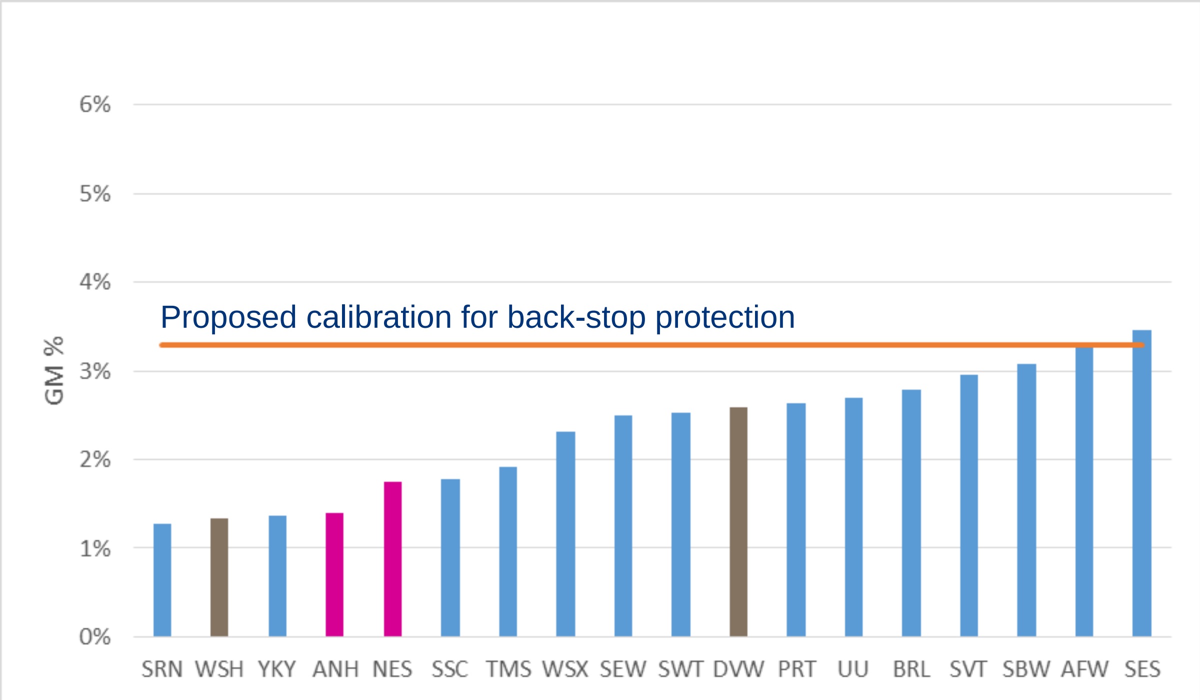
Additional detail on the average retail costs and net margin allocations proposed by companies is provided for information in Appendix 3.

3.3.3 Water over 50 mega litres uniform back-stop protection

Company proposals for gross margin in 2017/18 range from 1.3% for Southern Water to 3.5% for Sutton and East Surrey Water as shown in Figure 3.3 below.

Sutton and East Surrey Water have adopted a uniform 2.5% net margin across all default tariff caps in 2017/18 before moving to differentiated margins from 2018/19 onwards. At this point its gross margin reduces from 3.5% to 2.9%. All other companies have a gross margin of no more than 3.3% and so we have used the 3.3% as the maximum level that will apply to all the companies operating wholly or mainly in England and Wales (as customers of all companies using more than 50Ml of water will have access to water business retail market).

Figure 3.3: Company proposals for Gross Margins (water over 50 mega litres)



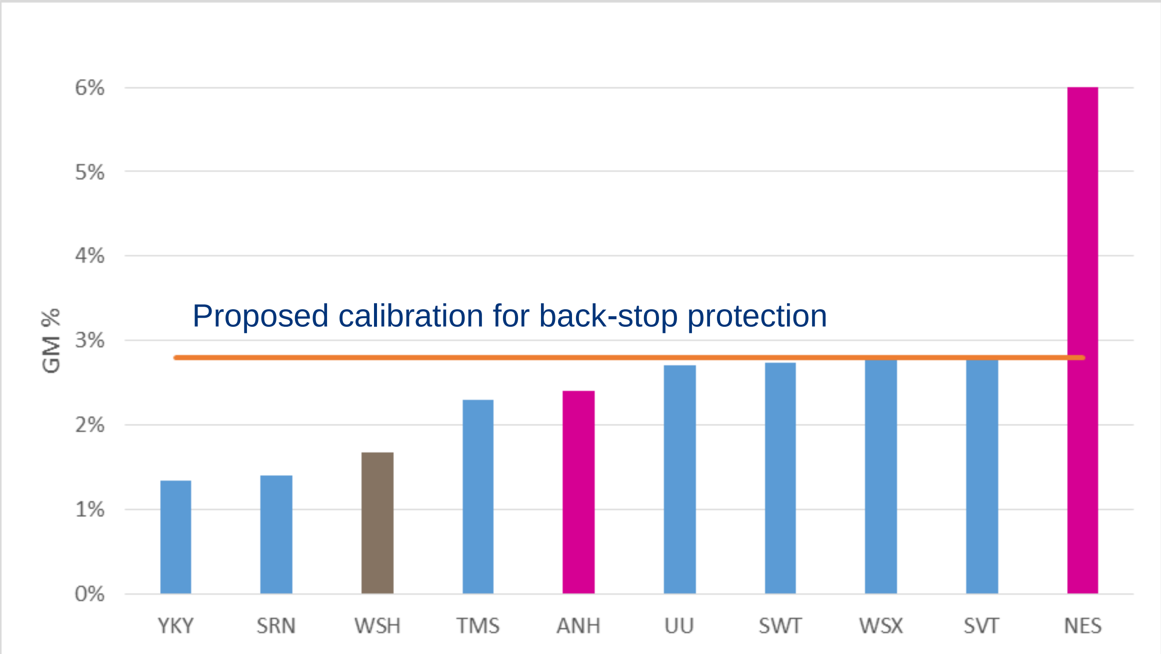
Additional detail on the average retail costs and net margin allocations proposed by companies is provided for information in Appendix 3.

3.3.4 Wastewater over 50 mega litres uniform back-stop protection

Company proposals for gross margin range in 2017/18 from 1.3% for Yorkshire Water to 11.3% for Northumbrian Water as shown in Figure 3.4 below. We have concerns about the accuracy of Northumbrian Water's data tables particularly in respect of this band. For all other companies the gross margin is no more than 2.8% (which is the level proposed by Severn Trent for the allocation of costs and margins to wastewater customers using more than 50 Ml per year) and this will apply to all the companies operating wholly or mainly in England.

This uniform control will not apply to Dŵr Cymru as wastewater is a non-contestable market in Wales.

Figure 3.4: Company proposals for Gross Margins (wastewater over 50 mega litres)



Note: NES has a projected GM of 11.3% which is truncated in this figure.

3.4 Supplementary restraint prohibiting increases

The preceding sections 3.3.1 to 3.3.4 highlight that there remains considerable variation between companies' allocations within the uniform bandings. For example, in section 3.3.1 covering water 5 to 50Ml, Yorkshire Water has an allocated gross margin of 1.5%, significantly below the uniform level of back-stop protection which has been set at 5%. To deal with any concerns about step changes in prices at market opening the statement of method said that any price rises to close headroom to the level of the gross margin back-stop protection should not exceed one per cent in any year.

Some companies expressed concern that a supplementary restraint could prevent them from achieving the overall allowed net margin of 2.5%. This is neither our intention nor an unintended consequence of the supplementary restraint. For the avoidance of doubt, the supplementary restraint of a maximum price increase of 1% per annum will only apply to the four uniform controls and its scope relates to increases in the retail charging component and as such would not restrain wholesale price movements permitted under the charging scheme rules.

4. Our overall assessment of company proposals

This chapter outlines our overall assessment of companies' PR16 proposals for the default tariff caps applying to 0 to 5Ml customers (larger customers are protected by the uniform bands and supplementary cap described in chapter 3). Company proposals are considered in three groups:

- those that we have accepted (section 4.1);
- those that we have accepted with minor adjustments (section 4.2); and
- proposals where sufficient evidence has not yet been provided and we have not accepted as the basis for these draft determinations (section 4.3).

4.1 Proposals we have accepted

Twelve companies submitted proposals that met the requirements we outlined in our statement of method. Some of these proposals involved no or inconsequential changes from PR14, others minor changes and the remainder more significant changes.

The thrust of our statement of method was to simplify the price control arrangements for larger customers and focus the price controls on backstop protection for those customers most able to take advantage of the competitive market. These matters are dealt with in chapter 3. For smaller customers (those using less than 5Ml per year) the emphasis was to make sure that any additional overall allowances for costs/margins proposed by companies were justified by substantial new evidence and that there was a high evidential bar for any rebalancing of cost/margin allocations that would increase prices for smaller customers.

We have assessed company proposals on this basis and accepted those where the level of assurance and evidence provided by companies as being commensurate with the level of change being proposed by companies – are set out below.

Proposals involving no or very limited change

Proposals involving no or very limited changes (for example, proposals involving small changes to estimates of eligible customer numbers that will have no substantial impact on its cost/margin allocations) and where we have received Board Assurance that the approach to cost/margin allocations adopted at PR14 remain appropriate. In these circumstances the proposals are consistent with our statement of method test on the overall level of costs/margins and the test that there is no rebalancing of costs/margins that causes price increases to smaller customers (unless such increases are justified by strong supporting evidence). In the light of these factors we have accepted the resulting default tariff caps as the basis for these draft determinations for customers using less than 5Ml per year for the following companies:

- Bristol Water;
- Portsmouth Water;
- Dee Valley Water; and
- South West Water.

For Dee Valley Water, recognising the different circumstances that applies in Wales, we will accept its proposal for default tariff caps for customers using less than 50MI of water and will apply our uniform gross margin controls for those customers using more than 50MI of water. See chapter 3 and Appendix 2 for more information.

Proposals involving minor changes

For companies proposing no increase in overall cost/margin levels and only minor changes from rebalancing (for instance where the result of the updating of cost/margin allocations there was a mixture of small increases and decreases in prices for customers using less than 5Ml per year) then we have accepted those supported by proportionate and reasonable evidence. This includes an appropriate level of evidence on any rebalancing that has been proposed and the expected impact of those changes on prices customers using less than 5MI of water and/or wastewater:

- Affinity Water;
- South Staffs;
- Sutton and East Surrey;
- South East Water; and
- Southern Water.

See Appendix 2 for more information on the assessment of these proposals.

Proposals involving more significant changes

Proposals involving more significant changes from rebalancing (in particular where there are price increases for smaller customers) have been tested on the basis of the draft statement of method and the requirements to be supported by strong and convincing evidence. For example, evidence supporting the approach to cost/margin allocations (including third party supporting evidence), evidence from companies' ongoing customer engagement, research and their day-to-day interactions with customers supporting any price changes and evidence of CCG engagement. Proposals accepted on this basis include those from:

- Severn Trent;
- United Utilities; and
- Wessex Water.

See Appendix 2 for more information on the assessment of these proposals.

4.2 Proposals that we have accepted with minor adjustments

Two companies – South West Water's proposal for the Bournemouth area[4] and Yorkshire Water – submitted proposals where important further information will be required before we will be able to accept the proposals as the basis for revised controls or where minor adjustments to the proposals are required.

4.2.1 Bournemouth

South West Water's proposal for the Bournemouth area involves relatively significant changes to the allocation of costs and margins through the adoption of the allocation methodology used by South West Water at PR14. It has largely provided a sufficient level of evidence to support its proposal.[5] However, there are two aspects of its proposals where further evidence and/or adjustment is required.

- **Total retail cost allowance**: the Bournemouth area is expecting – largely due to changes in eligibility – to lose more than 10% of its business customers but it has not reduced its overall business retail cost allowance to reflect the additional costs that will be recovered through the residential retail control. We estimate the

[4] Bournemouth Water's PR16 was prepared by South West Water due to these companies merging after our PR14 decisions were issued.
[5] For example, it provided both Board and third party assurance (Frontier Economics) for the changes that it has proposed to its allocation of costs and margins.

materiality of these matters is approximately £50,000 across the eligible customer base in the Bournemouth area.

- **Expected bill impacts**: the proposal includes significant bill increases for customers using less than 0.75Ml of water a year in the Bournemouth area[6] - with limited support customer research and engagement.

We have made an adjustment to the default tariff caps proposed South West Water for the Bournemouth area. This has involved £50,000 downward adjustment applied proportionately to the retail cost allowances across the default tariff caps for customers with volumes below 5Ml of water. The intention is to both protect customers from the recovery of unnecessary costs and from price increases not reasonably supported by customer engagement. South West Water will have the opportunity to accept our draft determination for the Bournemouth area or make further representations on these matters. See Appendix 2.3.4 for more information on our assessment of the proposals for the Bournemouth area.

4.2.2 Yorkshire Water

Yorkshire Water's proposal appears to involve relatively minor change as it largely involves updating its costs and margin allocations to reflect 2015/16 prices and splitting its measured 0 to 50Ml default tariff cap band into two to reflect our proposals for simplification. However, there is a lack of clarity with respect to two key aspects of its proposal and further evidence and information on these is required to demonstrate that its proposal is reasonable and robust.

- **Allocation of margins and costs**: Yorkshire Water's approach to the allocation of costs and margins between the measured 0 to 5Ml and measured 5 to 50Ml bands.
- **Expected bill impacts:** the expected impact of Yorkshire Water's proposals on customer bills. We are particularly interested in further information on the expected impact on customers using less than 5Ml of water a year. We recognise that Yorkshire Water has engaged its Customer Forum in developing its proposal and quotes information from customer engagement – but as a minimum we need Yorkshire Water to confirm the actual bill incidence effects (if any) of its proposals

[6] Those customers on volumes below 0.75Ml – which represents around 60% of the Bournemouth area customer base – will experience bill increase of 3.1%, while those using 0.75Ml to 2Ml will experience bill increases of 0.6%. The remaining customers will see bill reductions, including a 5.8% bill reduction for customers using between 4 and 5Ml of water a year.

and if appropriate to explain how these are consistent with the results of its customer engagement.

These draft determinations are based on the proposals made by Yorkshire Water on the basis that it will provide appropriate additional supporting evidence in response to these draft determinations. If it fails to do so we would consider using its PR14 default tariff caps as the basis for default tariff caps for under 5Ml customers at final determinations.

See Appendix 2.2.6 for more information on our assessment of Yorkshire Water's proposals for default tariff caps for customers using less than 5Ml per year.

4.3 Proposals where sufficient evidence has not yet been provided

Four companies – Anglian Water, Dŵr Cymru, Thames Water, and Northumbrian Water – have submitted proposals where the evidence provided has not been sufficiently comprehensive and/or robust for us to accept their proposals as the basis for these draft determinations.

For Anglian Water, Thames Water and Northumbrian Water we have retained the default tariff caps set at PR14 for customers using less than 5Ml per year. The uniform gross margin bands and supplementary cap will apply to their customers using more than 5Ml per year, as explained in chapter 3. Somewhat different arrangements will apply to Dŵr Cymru, reflecting the different competitive environment for companies operating wholly or mainly in Wales. For Dŵr Cymru we have retained all its PR14 default tariff caps, except for customers using more than 50Ml of water per year where the gross margin band will apply.

The proposals made by these companies all appear to involve significant changes to the PR14 default tariff caps. This means that the proposals need to satisfy the evidential tests set out in the statement of method, including that claims for additional cost/margin allowances are supported by substantial new information, that proposals for rebalancing that increase prices for smaller customers are supported by strong evidence (including evidence from companies' ongoing customer engagement, research and their day-to-day interactions with customers) and that the data tables that companies have provided as part of their proposals are robust and accurate.

The main issues with the four companies concerned is discussed below and in more detail in appendix 2.

4.3.1 Anglian Water

Anglian Water's proposal appears to involve significant change – for example, it has proposed that the overall cost allowance should be increased by 30% (relative to our PR14 assessment) to reflect its view of an appropriate level of costs and to help ensure it is not exposed to allegations of predation and /or margin squeeze[7]. We have the following concerns with Anglian Water's proposals:

- **Quality of evidence submitted**: we have already explained in chapter 3 that our assessment of the evidence that Anglian Water has provided supporting its suggestions for a significant increase in the overall cost allowances does meet the test of substantial new evidence as described in our statement of method. In addition, we were unable to reconcile its narrative with the information contained in its data tables, where a lower overall retail cost allowance appears to have been used compared to that allowed at PR14. This has undermined our confidence in both the Board assurance that it has given and in its calibration of its proposals for changes to its default tariff caps.
- **Expected bill impact**: while we welcome Anglian Water discussing the expected impact of its proposal on customers' bills with its Customer Engagement Forum, the evidence submitted suggests that only discussions on the overall impact of its proposal on customers' bills has occurred. If Anglian Water is proposing changes that will have significant bill impacts on individual groups of customers (which is difficult to determine given the lack of confidence we have in its data tables and the lack of disaggregated information on bill impacts) then its proposals for change should be accompanied by convincing evidence from customer engagement.

In light of the above, our assessment is that Anglian Water has not provided sufficiently robust evidence to support its proposals. See Appendix 2.3.5 for more information. Anglian Water now has an opportunity to respond to this draft determination and provide further information by 28 October 2016.

We also note Anglian Water's suggestion that it may not comply with the supplementary restraint on charges for larger (greater than 5 Ml) customers. We would take this into account in deciding on the treatment of Anglian in our company monitoring framework and in relation to possible enforcement action.

[7] These costs appear to be largely associated with developing a new retail operating model and those associated with retail separation

We further note that in its submission Anglian Water says that following Ofwat's statement of method would knowingly put it at serious risk of breaching competition law. We have been very clear in our statement of method about the approach we would follow in our PR16 determinations and about the evidence we required from companies to make changes to their default tariff caps. It is also for each company to ensure that it complies with all relevant legal obligations, including competition law. The risks associated with any failure to provide us with that evidence, and the competition law risks associated with each company's pricing decisions, rest squarely with each company.

4.3.2 Dŵr Cymru

Dŵr Cymru's proposal appears to involve important changes to its approach to allocating costs and margins. We have a number of concerns with Dŵr Cymru's proposals.

- **Allocation of costs and margins**: there was a lack of information supporting in relation to the allocation of costs/margins and so we were unclear as to why, for example, costs allocated to customers using more than 50Ml of water have fallen very significantly and why total retail costs should not fall in line with the reductions in expected customer numbers. Further we were not convinced by the arguments made by Dŵr Cymru that it should to smear the recovery of competitive margin across its contestable and non-contestable customer base – even if the price impact on smaller customers is relatively modest.
- **Expected bill impact**: further information is required on the expected impact of Dŵr Cymru's proposals on customer bills. We are particularly interested in obtaining further evidence on the expected impact on customers using less than 5Ml of water a year, but also on those using less than 50Ml of water a year. While we recognise that Dŵr Cymru has engaged its CCG and representatives of the business community, there is a lack of clarity as to what the expected bill impacts of its proposal will be on customers.

In light of the above, our assessment is that Dŵr Cymru has not provided sufficiently robust evidence to support its proposals. See Appendix 2.3.8 for more information. Dŵr Cymru now has an opportunity to respond to this draft determination and provide further information by 28 October 2016.

4.3.3 Thames Water

Thames Water's proposal appears to involve a number of changes – for example, rather than maintaining a flat 2.5% net margin across all its tariff bands its proposal involves allocating margins on a differentiated basis across its default tariff caps. It has also updated its allocation of costs. For some groups of customers these changes appear to lead to bill impacts. We have a number of concerns with the proposals from Thames Water – in particular the extent that its customer engagement supports some of its price changes.

- **Allocation of costs and margins**: while Thames Water has engaged PwC to assist it in revising its net margins and KPMG has provided assurance of its approach (including a review of compliance with the approach we outlined in our statement of method and Thames Water's internal governance arrangements), there remains a lack of transparency with respect to evidence that would support the actual changes.
- **Expected bill impact**: although Thames Water has estimated the expected impact of its proposals on customer bills, and it has undertaken some customer engagement, there are shortcomings in how its evidence supports it proposed bill increases. For instance, it appears that its proposed bill increases are sometimes more than twice the level of the £10 increase (for combined bills) that has been accepted by customers as reasonable.

In light of the above, our assessment is that Thames Water has not provided sufficiently robust evidence to support its proposals. See Appendix 2.3.7 for more information. Thames Water now has an opportunity to respond to this draft determination and provide further information by 28 October 2016.

4.3.4 Northumbrian Water

Northumbrian Water's proposal appears to involve a rebalancing of retail costs and wholesale charges between its default tariff caps and has also merged and split a number of default tariff caps to combine its Northern and Southern regions and to adopt the simplified structure.

It has also highlighted concerns about the overall level of retail cost allowances. These matters are addressed in section 2.1.

We have a number of concerns with Northumbrian Water's rebalancing proposals and the quality of data it has submitted.

- **Allocation of costs and margins**: only limited information has been provided to support the changes in cost allocations and we remain unclear as to how it has allocated its costs and margins to customers in the 0 to 5Ml and 5 to 50Ml bands.
- **Expected bill impact**: further information is required on the expected impact of Northumbrian Water's proposals on customer bills. The information we have suggests increases to small unmeasured customers in its Southern region and it is not clear whether these are supported by customer engagement.
- **Quality of evidence submitted**: There appears to be a quality assurance issue with the data tables provided by Northumbrian – including in relation to wastewater where it seems to be suggesting a relatively large number of very large customers.

In light of the above, our assessment is that Northumbrian Water has not provided sufficiently robust evidence to support its proposals. See Appendix 2.3.6 for more information. Northumbrian Water now has an opportunity to respond to this draft determination and provide further information by 28 October 2016.

5. Next steps

Having considered company submissions in reaching our draft determinations, companies and other stakeholders now have an opportunity to respond to these draft determinations by 28 October 2016.

We will consider any representations made to us and plan to publish final determinations on 15 December 2016.

The new price controls will come into effect from the start of April 2017 and will be in place for 3 years. They will be reviewed as part of the PR19 process. If further price controls are considered necessary, revised arrangements with be put in place to take effect from the start of April 2020.

Appendix 1: draft of the notification letter and notification

This appendix contains drafts of the notifications for the business retail price controls for all the companies (final versions of these drafts will be part of the legal process for implementing the revised price controls after final determinations) and these drafts are likely to be of most interest to companies.

DRAFT

15 December 2016

Dear [Chief Executive]

Final determination of business retail price controls

I enclose the formal notification of the determination by the Water Services Regulation Authority (Ofwat) of Price Controls for Business Retail Activities.[8] This sets out the Price Controls in respect of your Business Retail Activities starting from March 2017.

This final determination letter has also been published on our website.

You have two months from today to decide whether to ask us to refer the determination to the Competition and Markets Authority. If you wish to refer the determination you must let us know in writing no later than [15 February 2017].

Yours sincerely,

[8] Where Business retail activities refers to non-household retail activities described in licences.

A1.1 Draft of the Notification by the Water Services Regulation Authority of its determination of Price Controls for Business Retail Activities for [Company name] (“the Determination”)

A1.1.1 Introduction

This is the Determination by the Water Services Regulation Authority (“Ofwat”) as to the Price Controls for Business Retail Activities. It is made by Ofwat in accordance with Part III of Condition B (Charges) of your Appointment as a water and sewerage undertaker, having had regard to all the circumstances which are relevant in light of the principles which apply by virtue of Part I of the Water Industry Act 1991, including, without limitation:

- any change in circumstance which has occurred since the last Periodic Review or which is to occur; and
- the guidance issued by the Secretary of State for Environment, Food and Rural Affairs under section 2A of the Water Industry Act 1991.

The Price Controls will apply to the Charging Year starting on 1 April 2017 and the two subsequent Charging Years.

You must levy charges in a way best calculated to comply with the Price Controls.

Unless the contrary intention appears, words and expressions used in this document shall have the same meaning as in the Conditions of the Appointment.

A1.1.2 Price Control for Business Retail Activities

The Price Control for Business Retail Activities:

- consists of limits on the average revenues allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned for specific customer types;
- is set for a period of three consecutive Charging Years starting on 1 April 2017;
- does not impose any limit on the revenue allowed to the Appointed Business in respect of the Retail Activities concerned where a customer freely chooses to pay different charges to those that they would otherwise be liable for; and

- does not impose any limit on any revenue in respect of Retail Activities from Excluded Charges, charges (including charges for developer services) that are not Standard Charges or any miscellaneous charges that are not directly related to the supply of water, the provision of sewerage services, or the carrying out of trade effluent functions.

Total revenue allowed for customer types 1

The total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned for customer type 1 as outlined in Table 1 shall not exceed R calculated in accordance with the following formula:

$$\mathbf{R = [((r_c \times c_n) + w) / (1 - m)] - w}$$

Where:

r_c = the allowed average retail cost component for a given customer type (in pounds) as set out in Table 1;
c_n = the customer numbers for a given customer type;
w = the wholesale revenue for a given customer type; and
m = the allowed net margin for a given customer type (expressed as a percentage) as set out in Table 1.

For the purposes of this element of the Price Control for Business Retail Activities:

- "**customer types 1**" is a class of customers described in Table 1 by reference to the type of charge (known as a default tariff), fixed by or in accordance with a charges scheme under section 143 of the Water Industry Act 1991 or agreements with the persons to be charged, that is payable by them for any water supply or sewerage services provided by the Appointee or in connection with the carrying out of the Appointee's trade effluent functions;
- "**customer numbers**" means the average number of individual premises supplied or served by the Appointed Business in a Charging Year; and
- "**wholesale revenue**" means the revenue that the Appointee recovers in a Charging Year in respect of Wholesale Activities relating to the supply of water, the provision of sewerage services or the carrying out of trade effluent functions in relation to premises other than households (assuming for these purposes that the Appointee offered itself no more favourable terms in relation to payment than would be offered to any other person in respect of Wholesale Activities).

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Follow these hyperlinks to access company specific table. AFW, ANH, BRL, DVW, WSH, NES, PRT, SBW, SVT, SEW, SSC, SWT, SRN, SES, TMS, UU, WSX, YKY

Total revenue allowed for customer types 2

The total revenue allowed to the Appointed Business in each Charging Year in respect of the Retail Activities concerned for customer type 2 as outlined in Table 2 shall not exceed R calculated in accordance with the following formula:

$R = g_m \times w$

Where:

g_m = the allowed gross margin for a given customer type (expressed as a percentage) as set out in Table 2; and
w = the wholesale revenue for a given customer type.

For the purposes of this element of the Price Control for Business Retail Activities:

- "**customer types 2**" is a class of customers described in Table 2 by reference to the type of charge (known as a gross margin default tariff), fixed by or in accordance with a charges scheme under section 143 of the Water Industry Act 1991 or agreements with the persons to be charged, that is payable by them for any water supply or sewerage services provided by the Appointee or in connection with the carrying out of the Appointee's trade effluent functions;
- "**customer numbers**" means the average number of individual premises supplied or served by the Appointed Business in a Charging Year; and
- "**wholesale revenue**" means the revenue that the Appointee recovers in a Charging Year in respect of Wholesale Activities relating to the supply of water, the provision of sewerage services or the carrying out of trade effluent functions in relation to premises other than households (assuming for these purposes that the Appointee offered itself no more favourable terms in relation to payment than would be offered to any other person in respect of Wholesale Activities).

Table 2 Business customer types and allowed gross margins

Follow these hyperlinks to access company specific table. AFW, ANH, BRL, DVW, WSH, NES, PRT, SBW, SVT, SEW, SSC, SWT, SRN, SES, TMS, UU, WSX, YKY

A1.2 Affinity Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
AFW Metered 0-5 Ml, including assessed customers and unmeasured RV customers	r_c (£)	47.45	46.38	45.12
	m %	2.94%	2.94%	2.94%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.3 Anglian Water Services Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Unmeasured (potable water)	r_c (£)	14.70	14.70	14.69
	m %	3.72%	3.72%	3.72%
Hartlepool Unmeasured (potable water)	r_c (£)	12.33	12.32	12.31
	m %	4.86%	4.83%	4.80%
Streamline Green (potable water) - (0.0Ml to 0.5Ml)	r_c (£)	34.32	34.28	34.24
	m %	4.57%	4.55%	4.53%
Streamline Orange (potable water)-(0.5Ml to 5.0Ml)	r_c (£)	92.00	91.94	91.88
	m %	2.29%	2.29%	2.29%
Streamline Orange (non-potable water) - (0.0Ml to 5.0Ml)	r_c (£)	67.07	67.12	67.17
	m %	2.57%	2.55%	2.54%
Unmeasured (Sewerage)	r_c (£)	15.60	15.61	15.61
	m %	3.31%	3.31%	3.32%
Streamline Green (Sewerage) - (0.0Ml to 0.5Ml)	r_c (£)	32.60	32.59	32.57
	m %	3.59%	3.59%	3.58%
Streamline Orange (Sewerage) - (0.5Ml to 5.0Ml)	r_c (£)	49.11	49.02	48.93
	m %	1.56%	1.56%	1.57%
Unmeasured (Trade Effluent)	r_c (£)	18.94	18.89	18.84
	m %	3.48%	3.44%	3.40%
Streamline Green (Trade Effluent) - (0.0Ml to 0.5Ml)	r_c (£)	173.41	172.71	171.96
	m %	7.13%	7.04%	6.93%
Streamline Orange (Trade Effluent) - (0.5Ml to 5.0Ml)	r_c (£)	153.27	152.54	151.76
	m %	3.73%	3.68%	3.62%
*Hartlepool Commercial	r_c (£)	27.45	27.45	27.45

Customer type	Units	2017-18	2018-19	2019-20
(potable water) - (0.0Ml to 50.0Ml)	m %	3.64%	3.66%	3.68%
*Special Agreements (non-potable water) - (0.0Ml +)	r_c (£)	426.44	426.64	426.87
	m %	0.69%	0.71%	0.73%
*Special Agreements (potable water) - (0.0Ml +)	r_c (£)	426.44	426.64	426.87
	m %	0.76%	0.78%	0.80%

Tariffs marked with * are not necessarily allocated to the 0-5ML volume band, but there may be customers on that tariff who are so they have been included.

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.4 Bristol Water plc

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Band F - 1-5Ml	r_c (£)	42.48	42.69	42.91
	m %	1.80%	1.82%	1.84%
Band G - 0-1Ml	r_c (£)	24.46	24.43	24.41
	m %	3.82%	3.74%	3.66%
Band U	r_c (£)	7.67	7.65	7.64
	m %	4.34%	4.20%	4.07%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.5 Dee Valley Water Plc

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Tariff band 01 - Unmeasured	r_c (£)	28.94	29.07	29.45
	m %	1.0%	1.0%	1.0%
Tariff band 02 – Measured less than 50Ml	r_c (£)	31.62	31.75	32.11
	m %	1.0%	1.0%	1.0%
Tariff band 03 – Untreated measured less than 50Ml	r_c (£)	29.90	29.90	29.90
	m %	1.0%	1.0%	1.0%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.6 Dŵr Cymru Cyfyngedig

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Raw Water < 50Ml (Measured)	r_c (£)	29.55	27.27	27.27
	m %	1.00%	1.00%	1.00%
Partially Treated Water < 50Ml (Measured)	r_c (£)	40.64	37.51	37.51
	m %	1.00%	1.00%	1.00%
Potable Water < 50Ml (Non Household)	r_c (£)	34.71	32.06	32.07
	m %	1.00%	1.00%	1.00%
Potable Water < 50Ml (Non Household)	r_c (£)	17.94	16.98	17.41
	m %	1.00%	1.00%	1.00%
Sewerage Measured <100Ml	r_c (£)	36.39	33.62	33.64
	m %	1.00%	1.00%	1.00%
Sewerage Un-Measured <100Ml	r_c (£)	16.72	15.85	16.28
	m %	1.00%	1.00%	1.00%
Sewerage Measured > 100Ml	r_c (£)	3921.21	3619.39	3619.39
	m %	1.00%	1.00%	1.00%
Sewerage Trade Effluent <100Ml	r_c (£)	180.10	166.24	166.24
	m %	1.00%	1.00%	1.00%
Sewerage Trade Effluent >100Ml	r_c (£)	3457.47	3191.34	3191.34
	m %	1.00%	1.00%	1.00%
Outfall Tariff	r_c (£)	1217.81	1124.08	1124.08
	m %	1.00%	1.00%	1.00%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
*Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

*Water over 50Ml includes tariffs designated as special agreements at PR14.

A1.7 Northumbrian Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Cust type 01, Unmeasured, Unmeas Water N, Unmeasured	r_c (£)	18.62	18.95	19.31
	m %	6.03%	6.03%	6.03%
Cust type 02, Unmeasured, Unmeas Water S, Unmeasured	r_c (£)	25.37	26.13	26.98
	m %	3.66%	3.66%	3.66%
*Cust type 03, Measured, Meas Water N std, Measured	r_c (£)	31.37	31.31	31.24
	m %	3.90%	3.90%	3.90%
Cust type 07, Measured, Meas Water S std, Measured	r_c (£)	24.09	24.04	23.99
	m %	3.34%	3.34%	3.34%
Cust type 11, Unmeasured, Unmeas Sew, Unmeasured	r_c (£)	21.91	22.27	22.67
	m %	4.55%	4.55%	4.55%
*Cust type 12, Measured, Meas Sew - std, Measured	r_c (£)	30.56	30.45	30.33
	m %	2.34%	2.34%	2.34%
*Cust type 14, Measured, Trade Effluent - std, Measured	r_c (£)	240.17	239.53	238.89
	m %	1.37%	1.37%	1.37%
*Cust type 15, Measured, Ind Water, Measured	r_c (£)	2664.84	2664.48	2664.18
	m %	0.75%	0.75%	0.75%
*Cust type 16, Measured, Trade Effluent - Special Agreement, measured	r_c (£)	2573.05	2572.47	2571.81
	m %	0.69%	0.69%	0.69%

Tariffs marked with * are not necessarily allocated to the 0-5ML volume band, but there may be customers on that tariff who are so they have been included.

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.8 Portsmouth Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Water Unmeasured Non-Household	r_c (£)	16.67	16.71	16.72
	m %	2.28%	2.18%	2.19%
Water Measured Non-Household < 5Ml	r_c (£)	20.22	20.13	20.12
	m %	2.40%	2.40%	2.40%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.9 Bournemouth Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Domestic Commercials unmetered	rc (£)	16.28	15.69	14.81
	m %	1.89%	1.85%	1.82%
Standard measured water <5 Ml	rc (£)	23.05	22.43	21.51
	m %	3.02%	3.01%	3.01%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml*	g_m %	3.3%	3.3%	3.3%

Water over 50 Ml includes the single special agreement customer for Bournemouth Water

A1.10 Severn Trent Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Water: Unmeasured and 0-5 Ml/a	r_c (£)	41.94	43.80	45.24
	m %	3.79%	3.86%	3.73%
Waste Water: Unmeasured and 0-5 Ml/a	r_c (£)	42.20	44.03	45.39
	m %	2.79%	2.82%	2.85%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.11 South East Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Portable Water - Unmetered	r_c (£)	36.29	36.26	36.41
	m %	1.15%	1.14%	1.14%
Potable Water - Metered 0-2.5 Ml/a	r_c (£)	35.58	35.97	36.42
	m %	2.73%	2.73%	2.73%
Potable Water - Metered 2.5-5 Ml/a	r_c (£)	68.12	68.52	68.96
	m %	2.27%	2.27%	2.27%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.12 South Staffs Water Plc

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Unmeasured and measured 0-5 Ml/a	r_c (£)	46.31	45.30	44.64
	m %	2.96%	2.96%	2.96%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.13 South West Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Standard Unmeasured Water	r_c (£)	13.58	13.53	13.26
	m %	1.94%	1.90%	1.87%
Standard Unmeasured Sewerage	r_c (£)	15.17	15.12	14.84
	m %	1.94%	1.90%	1.87%
Standard measured water <5Ml	r_c (£)	16.02	15.97	15.70
	m %	3.14%	3.15%	3.13%
Standard measured sewerage <5Ml inc TE	r_c (£)	15.36	15.36	15.21
	m %	2.77%	2.76%	2.74%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.14 Southern Water Services Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Standard Water - Unmetered	r_c (£)	12.29	12.41	12.41
	m %	2.16%	2.16%	2.17%
Standard 0-1ML p.a. Water Metered	r_c (£)	23.30	23.52	23.52
	m %	6.30%	6.31%	6.32%
Standard 1-5ML p.a. Water Metered	r_c (£)	81.43	82.19	82.20
	m %	2.83%	2.84%	2.84%
Standard Sewerage Unmetered	r_c (£)	15.14	15.29	15.29
	m %	1.95%	1.95%	1.95%
Standard 0-1ML p.a. Sewerage Metered	r_c (£)	25.48	25.72	25.72
	m %	3.62%	3.62%	3.62%
Standard 1-5ML p.a. Sewerage Metered	r_c (£)	98.39	99.31	99.31
	m %	1.98%	1.98%	1.98%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.15 Sutton and East Surrey Water Plc

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Unmeasured	r_c (£)	19.01	19.13	19.19
	m %	2.50%	2.61%	2.61%
0 to 5 Ml measured	r_c (£)	29.48	29.66	29.76
	m %	2.50%	2.61%	2.61%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%

A1.16 Thames Water Utilities Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
[0-500] [0-500m3] [water] [metered]	r_c (£)	26.16	26.24	25.94
	m %	2.50%	2.53%	2.53%
[500-1,000] [500-1,000m3] [water] [metered]	r_c (£)	58.72	60.26	58.53
	m %	2.52%	2.48%	2.53%
[1,000-5,000] [1,000-5,000m3] [water] [metered]	r_c (£)	55.69	56.83	55.73
	m %	2.50%	2.50%	2.50%
[0-500] [0-500m3] [sewerage] [metered]	r_c (£)	30.23	29.98	30.28
	m %	2.48%	2.46%	2.48%
[500-1,000] [500-1,000m3] [sewerage] [metered]	r_c (£)	56.99	56.64	56.92
	m %	2.55%	2.48%	2.47%
[1,000-5,000] [1,000-5,000m3] [sewerage] [metered]	r_c (£)	78.76	78.73	78.58
	m %	2.50%	2.50%	2.50%
[0 - 500] [0 - 500m3] [trade effluent] [metered]	r_c (£)	32.03	31.99	32.20
	m %	2.45%	2.41%	2.39%
[500-1,000] [500-1,000m3] [trade effluent] [metered]	r_c (£)	58.52	58.46	58.40
	m %	2.60%	2.52%	2.54%
[1,000-5,000] [1,000-5,000m3] [trade effluent] [metered]	r_c (£)	78.48	78.40	78.60
	m %	2.52%	2.52%	2.50%
[0 - 500 Business Assessed] [0 - 500m3] [water] [unmetered]	r_c (£)	25.96	26.03	25.79
	m %	2.78%	2.70%	3.02%
[500 - 1,000 Business Assessed] [500 - 1,000m3] [water] [unmetered]	r_c (£)	59.75	60.65	59.16
	m %	2.42%	2.54%	2.50%
[1,000 - 5,000 Business Assessed] [1,000 - 5,000m3] [water] [unmetered]	r_c (£)	55.83	56.83	55.75
	m %	2.49%	2.50%	2.50%

[0 - 500 Business Assessed] [0 - 500m3] [sewerage] [unmetered]	r_c (£)	28.19	27.95	28.28
	m %	2.52%	2.54%	2.50%
[500 - 1,000 Business Assessed] [500 - 1,000m3] [sewerage] [unmetered]	r_c (£)	58.25	58.19	58.38
	m %	2.45%	2.43%	2.42%
[1,000 - 5,000 Business Assessed] [1,000 - 5,000m3] [sewerage] [unmetered]	r_c (£)	78.52	78.44	78.81
	m %	2.53%	2.54%	2.47%
[Unmeasured RV + Fixed] [N/A] [water] [unmetered]	r_c (£)	26.56	26.54	26.60
	m %	2.54%	2.51%	2.54%
[Unmeasured RV + Fixed] [N/A] [sewerage] [unmetered]	r_c (£)	27.22	26.98	27.54
	m %	2.50%	2.51%	2.52%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.17 United Utilities Water Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Water 0 to 5Ml	r_c (£)	35.05	34.93	34.95
	m %	2.87%	2.85%	2.84%
Wastewater 0 to 5Ml	r_c (£)	52.51	52.58	52.56
	m %	2.87%	2.85%	2.84%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.18 Wessex Water Services Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
UM-W; Water unmetered	r_c (£)	19.32	19.25	19.12
	m %	1.46%	1.45%	1.45%
UM-S; Sewerage unmetered	r_c (£)	15.45	15.41	15.32
	m %	1.50%	1.54%	1.57%
M-W-0; 0-1 Ml Water metered	r_c (£)	22.99	22.90	22.74
	m %	3.32%	3.31%	3.30%
M-S-0; 0-1 Sewerage metered	r_c (£)	17.19	17.12	17.00
	m %	3.39%	3.40%	3.41%
M-TE-0; 0-1 Ml Trade Effluent metered	r_c (£)	22.97	22.88	22.72
	m %	3.25%	3.27%	3.31%
M-W-1; 1-5 Ml Water metered	r_c (£)	46.52	46.33	46.02
	m %	2.39%	2.38%	2.37%
M-S-1; 1-5 Sewerage metered	r_c (£)	40.07	39.91	39.64
	m %	2.47%	2.47%	2.48%
M-TE-1; 1-5 Ml Trade Effluent metered	r_c (£)	44.36	44.18	43.88
	m %	2.47%	2.48%	2.49%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

A1.19 Yorkshire Water Services Limited

Table 1 Business customer types, allowed average retail cost components and allowed net margins

Customer type	Units	2017-18	2018-19	2019-20
Tariff Band 4 - Water unmetered	r_c (£)	17.67	17.10	17.34
	m %	11.70%	11.76%	11.71%
Tariff Band 8 - Sewerage unmetered	r_c (£)	17.79	17.22	17.47
	m %	7.13%	7.09%	7.03%
Water 0 - 5 Ml	r_c (£)	26.85	26.10	26.38
	m %	3.54%	3.55%	3.55%
Wastewater 0 - 5 Ml	r_c (£)	28.93	28.16	28.48
	m %	2.95%	2.94%	2.93%
Trade Effluent 0 - 5 Ml	r_c (£)	23.10	22.45	22.74
	m %	2.27%	2.31%	2.35%

Table 2 Business customer types and allowed gross margins

Customer type	Units	2017-18	2018-19	2019-20
Water 5 to 50 Ml	g_m %	5.0%	5.0%	5.0%
Wastewater 5 to 50 Ml	g_m %	5.3%	5.3%	5.3%
Water over 50 Ml	g_m %	3.3%	3.3%	3.3%
Wastewater over 50 Ml	g_m %	2.8%	2.8%	2.8%

Appendix 2: summary of company proposals and our assessment

This annex provides, for each company, a summary of their PR16 proposals, the key evidence submitted, our assessment and our draft determinations.

A2.1 Proposals for no or very limited changes

A2.1.1 Bristol Water

Summary of company proposal

Bristol Water is proposing to simplify its default tariff caps by reducing them from eight to five – this includes merging its three largest caps into one over 50Ml cap. It does, however, propose to retain three default tariff caps set at PR14 for smaller customers (those using less than 5Ml).

Summary of evidence

It has provided Board assurance and its CCG has been kept informed of its proposals.

Assessment of proposal

Bristol Water proposes no overall cost and margin claims and no cost or margin reallocations. No bill impacts are expected for business customers using less than 5Ml and there is no significant change in the number of customers.

Decision

In the light of the very limited changes we have accept Bristol Water's PR16 proposals for the following default tariff caps: 0 to 1Ml, 1 to 5Ml and unmeasured. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.1.2 Dee Valley Water

Summary of company proposal

Dee Valley Water has proposed leaving its overall costs and margins, customer numbers and allocations unchanged. It also provided information on cost and margin allocations to a possible 0 to 5Ml default tariff cap (based on its existing 0 to 50Ml cap).

Summary of evidence

The information provided by Dee Valley Water in support of the illustrative 0 to 5Ml cap is not comprehensive, but this is not of significant concern given the different arrangements for competition applying in Wales. Board assurance has been provided.

Assessment of proposal

As competition only applies only to Dee Valley Water's customers using more than 50Ml per year we accept its proposal to retain its existing default tariff caps for its other customers. As competition applies to customers using more than 50Ml, our uniform gross margin cap will apply to these customers.

Decision

In the light of the above we will retain Dee Valley Water's PR14 default tariff caps for those customers using less that 50MI and apply a gross margin cap to those customers using more than 50Ml.

A2.1.3 Portsmouth Water

Summary of company proposal

Portsmouth Water's proposal involves adjusting its existing default tariff caps to unmeasured, 0 to 5Ml, 5 to 50Ml and more than 50Ml to reflect our proposals for simplifying controls for larger customers. Most of its customers will be covered by the new 0 to 5Ml cap. Apart from allocating costs and margins to reflect the 5Ml threshold it is not proposing other significant changes.

Summary of evidence

Portsmouth Water considers that the cost and margin allocation used at PR14 remains reasonable, as such it has not engaged with its CCG or customers. It also expects no significant change in customer numbers. Limited information has been provided on the expected bill impact, however, smaller customers are not expected to be affected. High-level Board assurance was provided.

Assessment of proposal

Portsmouth Water is proposing only minor changes (triggered by the introduction the uniform bands for customers using more than 5Ml per year) so we intend to accept its proposals.

Decision

Accept Portsmouth Water's PR16 proposal for the following default tariff caps: unmeasured and 0 to 5Ml. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.1.4 South West Water

Summary of company proposal

South West Water proposes to reduce its default tariff caps from 13 to 8 consistent with our simplified structure. Its revised structure has three bands (0 to 5Ml, 5 to 50Ml and 50+Ml) for both water and wastewater customers and two unmeasured tariff caps. It plans to keep its overall cost to serve and net margin allocations unchanged as it considers its PR14 allocations remain robust. While expecting a slight increase in customer numbers due to revised eligibility it has not updated its customer numbers as the changes are considered inconsequential.

Summary of evidence

South West Water has provided Board assurance of its proposal and discussed its proposals with its CCG. Frontier Economics has also provided external assurance of its proposed cost and margin allocations.

Assessment of proposal

South West Water has made no overall cost or margin claims. Its approach to simplification has resulted in no significant rebalancing of costs and margins. It has, however, had to make adjustments to adapt its pre-existing 0 to 50Ml default tariff caps for both water and wastewater customers as they straddled the 5Ml threshold, but this is not expected to have bill impacts. Overall, South West Water's proposals are acceptable given the limited scope of the changes.

Decision

We accept South West Water's proposals for the following default tariff caps: unmeasured water, unmeasured wastewater, measured 0 to 5Ml water and measured 0-5Ml wastewater. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.2 Proposals involving minor changes

A2.2.1 Affinity Water

Summary of company proposal

Affinity Water is proposing to refine its approach to cost and margin allocations using the most recent 2015/16 costs and simplifying the structure of its default tariff caps – to 0 to 5Ml, 5 to 50Ml and 50+Ml bands. These changes are expected to only have a minor impact on customers.

Summary of evidence

Affinity Water provided a reasonably detailed submission supporting the refinements it has made to cost and margin allocations. It has provided a Board assurance and confirmed that customers will not face more than a 0.5% increase in bills. An assurance report from Frontier Economics on cost/margin allocations was also made available.

Assessment of proposal

Affinity Water's proposal is acceptable given the modest bill impacts and the evidence it has provided supporting its revised approach to cost and margin allocations.

Decision

Accept Affinity Water's PR16 proposals for the default tariff caps for those customers using less than 5Ml. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.2.2 South East Water

Summary of company proposal

South East Water's proposal includes updated cost and margin allocations. It has also split a pre-existing default tariff caps to create two caps: 0 to 2.5Ml and 2.5 to 5Ml. These actions are expected to have a minor impact on the bills of small customers.

Summary of evidence

South East Water has provided Board assurance on its proposal, which mentions consumer engagement, however, no evidence was found on consumer engagement activities in its submission.

Assessment of proposal

South East Water has split its existing 0 to 5MI default tariff cap to reflect different metering and billing costs incurred to serve different groups of smaller customers. More than 90% of customers will be in the 0 to 2.5MI band; their bills should decrease by 0.3%. Unmetered customers are expected to experience a bill increase of 1.5%. While there is some concern regarding the ambiguous position of customer engagement, particularly in light of a bill increase to a small number of unmeasured customers, the proposal is acceptable given the modest overall materiality (approximately £20k) of the increase for unmetered customers.

Decision

Accept South East Water's proposals for the following default tariff caps: unmetered, 0 to 2.5Ml and 2.5 to 5Ml. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.2.3 Southern Water

Summary of company proposal

Southern Water’s proposal includes changes to restructure its default tariff caps over 5Ml to comply with our uniform bands, it also combines sewerage and trade effluent tariff bands above and below the 5Ml threshold and its projections of eligible customers increase significantly.

Summary of evidence

Southern Water has provided Board assurance. The company has also subjected its default tariff structure, eligibility checks and data tables to external audit.

Assessment of proposal

Southern Water’s does not make any overall cost or margins claims. While customer numbers are expected to increase (mainly due to data cleansing), per customer costs fall slightly and net margins have remained stable. No bill impacts are expected as a result of the proposed measures and overall Southern Water’s proposals are acceptable.

Decision

Accept Southern Water’s proposals for the following default tariff caps: unmetered, 0 to 1Ml and 1 to 5Ml for both water and wastewater. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.2.4 South Staffs Water

Summary of company proposal

South Staffs proposes to decrease the number of their default tariff caps from 10 to 3. Given similar costs to serve, customers in the unmeasured and the 0 to 5Ml default tariff caps have been merged. It also proposes to reallocate its net margins across their default tariff caps in contrast with their previous approach of a fixed 2.5% margins across all bands.

Summary of evidence

South Staffs has provided assurance that merging all its pre-existing default tariff caps applying to customers consuming less than 5Ml into a single default tariff cap will not have a significant impact on customer bills. It has also provided Board assurance that the allocations made are reasonable and robust. South Staffs has also provided evidence of limited customer engagement and external assurance (from Frontier Economics) with respect to its margin reallocations.

Assessment of proposal

South Staffs has made no cost or margin claims. The proposed cost reallocation causes the average cost to serve to rise for customers in the 50+Ml band and fall slightly for customers in the 0 to 5Ml band. Its reallocation of net margins suggests a bill increase of less than 0.5% for customers using less than 5Ml. Customer numbers are unchanged from their PR14 levels. Overall, given the modest bill impacts, and the external support on margin reallocations, its proposals are acceptable.

Decision

Accept South Staffs proposals for the following default tariff cap: 0 to 5Ml. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.2.5 Sutton and East Surrey Water

Summary of company proposal

Sutton and East Surrey Water's approach largely involves abolishing the distinction made at PR14 between its southern and northern regions and splitting its existing 0 to 10Ml default tariff cap at the 5Ml threshold. These actions will result in the number of its default tariff caps falling from ten to six. Some minor cost reallocations have been necessary to reflect its proposed changes.

Summary of evidence

Sutton and East Surrey Water has provided a Board assurance with its proposals.

Assessment of proposal

Sutton and East Surrey Water is not making any overall cost or margin claims. It is, proposing some minor cost re-allocation due to the splitting of its 0 to 10Ml default tariff cap. Bills are expect to fall marginally for smaller customers (in the 0 to 5Ml band) while a small rise will be experienced by larger customers. Overall, its proposal is acceptable.

Decision

Accept Sutton and East Surrey Water's proposals for the following default tariff caps: unmeasured and 0 to 5Ml. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.2.6 Yorkshire Water

Summary of company proposal

Yorkshire Water has proposed to change its default tariff caps structure to split the measured 0 to 50Ml band into two (measured 0 to 5Ml and measured 5 to 50Ml) reflecting our simplification guidance. Minor changes to retail cost to serve and margin allocations have been made to reflect 2015/16 costs.

Summary of evidence

Yorkshire Water has provided Board assurance and has also provided evidence of customer engagement, but there is a lack of transparency about the impact on bills (if any).

Assessment of proposal

Yorkshire Water makes no overall cost or margin claims and it does not expect a change in the number of customers. There is lack of transparency about the allocations used to separate the 0 to 50Ml band and the company has adopted identical cost per customer allowances for the two new bands. Bill impacts for consumers in the 0 to 5Ml and 5 to 50Ml bands have not been presented.

No significant changes have been proposed by Yorkshire Water so it is unlikely that there will be material incidence effects. However, the lack of transparency about bill impacts needs to be addressed. We will require appropriate evidence, transparency and reassurance on the expected bill impacts for smaller customers.

Decision

Accept Yorkshire Water's PR16 proposals for the less than 5Ml default tariff caps conditional on receiving appropriate transparency and reassurance on bill impacts for small customers. We will apply our uniform gross margin controls for those customers using more than 5Ml.

If Yorkshire Water were not to provide appropriate further information and assurance we would consider using its PR14 default tariff caps for less than 5Ml customers as the basis for its final determinations.

A2.3 Proposals involving more significant change

A2.3.1 United Utilities

Summary of company proposal

United Utilities has proposed changes to both costs and net margin allocations including a rebalancing of net margins across its portfolio of default tariff caps, departing from a flat 2.5% net margin across all caps set at PR14. It plans to reduce its default tariff caps from 15 to 6 in order to align to our simplified structure. Its proposals include a significant decrease in customer numbers but this is associated with a change in the counting of customers receiving multiple services rather than a loss of customers due to the revised eligibility criteria.

Summary of evidence

United Utilities has submitted a comprehensive package of detailed supporting evidence commensurate with the degree of change proposed. This includes Board assurance supplemented by external reports from Frontier Economics, PwC, Populus and engagement with its CCG (YourVoice).

Assessment of proposal

United Utilities does not propose any overall cost or margin claims. In respect of changes to cost and net margin allocations, it plans to allocate key account management activities to large customers, add fixed costs to small sewerage customers and rebalance net margins across its default tariff caps to reflect different levels of capital employed and risk profiles associated with different customer groups. Supporting evidence demonstrates that the loss of customers (roughly

56,000) is due to a change in its approach to counting customers receiving multiple services and does not relate to eligibility criteria. A modest bill impact of +0.8% is expected for smaller customers (those using less than 5Ml) as a result of rebalancing. United Utilities' proposal is acceptable given the modest bill increase and the quality of evidence provided.

Decision

We have accepted United Utilities' proposals for the following default tariff caps: 0 to 5Ml water and 0 to 5Ml wastewater. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.3.2 Wessex Water

Summary of company proposal

Wessex Water's proposal involves scrapping its plans to introduce mixed use tariffs, decreasing the total number of default tariff caps by eight. It has also revised its allocations of net margins and costs.

Summary of evidence

Wessex Water provided Board assurance and informed its CCG of its proposal. Its reallocations of margins and costs have been supported by an external report prepared by Frontier Economics.

Assessment of proposal

Wessex Water makes no overall cost or margin claims. It has however revised its method for allocating net margins across default tariff caps; it proposes to allocate any residual unattributed margin evenly across customer groups.

The significant decline in customers (28,000 fewer than at PR14) is reflected in a proportional decrease in total costs and is therefore not a concern. The changes proposed in cost and margin allocation imply a minor bill increase (0.6%) for small customers (but mixed use customers will no longer experience the significant price rises previously envisaged). Price incidence impacts are supported by customer and CCG engagement. Overall, Wessex Water's proposal is acceptable given the evidence provided and small price rises.

Decision

Accept Wessex Water' proposals for the following default tariff caps: unmeasured water, 0 to 1MI water metered, unmeasured sewerage, 0 to 1MI sewerage metered, 0 to 1MI trade effluent metered, 1-5MI water metered, 1 to 5MI sewerage metered, 1 to 5MI trade effluent metered. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.3.3 Severn Trent Water

Summary of company proposal

Severn Trent Water is proposing to abolish 12 default tariff caps and move to three caps (0 to 5Ml, 5 to 50Ml and 50+Ml) for both the water and wastewater.

It has re-allocated costs resulting in higher bills for larger customers and lower bills for smaller customers and has proposed changes to the way it counts customers for purposes of the default tariff caps.

Summary of evidence

A reallocation of costs to mirror the higher cost of serving higher use customers was supported by detailed explanation. Severn Trent Water has provided credible supporting information in relation to the price reductions for smaller customers. Board assurance has been provided as has evidence of customer research and CCG and CCWater involvement.

Assessment of proposal

Severn Trent Water makes no overall cost or margin claims. Its customer numbers are expected to fall given the change in the way that it counts business customers. The re-allocation of costs to higher use customers means that bills for smaller customers are expected to decrease between 0.2% and 2%. Adjustments to its proposed default tariff have also occurred to reflect the 5Ml threshold. Overall, Severn Trent Water's proposal is acceptable given that prices faced by smaller customers (those using less than 5Ml) are expected to fall. Moreover, it has provided a proportionate and satisfactory level of evidence and assurance.

Decision

Accept Severn Trent Water's proposals for the following four default tariff caps: unmeasured and 0 to 5Ml water/wastewater. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.3.4 Bournemouth

Summary of company proposal

South West Water has proposed that the caps for the Bournemouth area reflect South West Water's cost and margin allocation methodology (to increase transparency and ensure consistency with competition law). To address simplification it plans to reduce from 8 default tariff caps to 5. The reallocation of costs and margins is expected to have an impact on consumer bills.

Summary of evidence

Frontier Economics has provided assurance on cost and margin allocations. Board assurance and evidence of discussions with the Bournemouth Customer View Group has been provided. Customer research was undertaken by ICS consulting and is summarised in the submission.

Assessment of proposal

There are no overall cost or margin claims but there are significant changes to the PR14 cost and margin allocations. The proposed rebalancing is expected to have an impact on customer bills, particularly smaller customers. Those customers in the less than 0.75Ml band (70% of all business customers) will experience an increase of 3.1% (£4.85 p.a.); a marginal increase is also expected for the 0.75 to 2Ml group.

Larger customers should experience bill reductions (i.e. a 5.8% bill reduction for the 4 to 5Ml band). The customer research shows large support for the phasing in of price increases, however South West Water does not plan to adopt such an approach. Customer numbers have decreased by 10%, due to eligibility, but it proposes no change to the retail cost allowance set at PR14. Overall, it is not clear that the 3% increase in bills for small customers is reasonable. We consider that a reduction in its retail cost allowance (to reflect the fact that customers not eligible for competition will be classified as residential and generate a cost allowance under the residential price control) and greater focus on protecting the interests of smaller customers is appropriate.

Decision

We have adjusted the proposals for unmeasured water and 0 to 5Ml default tariff caps to incorporate a £50,000 aggregate reduction in retail costs. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.3.5 Anglian Water

Summary of company proposal

Anglian Water appears to be seeking costs that are 30% higher than its PR14 assessment based on the implementation of its proposed new target operating model. It considers that retaining the PR14 level of business costs would risk it breaching competition law as it could be exposed to allegations of predation and/or margin squeeze. It has also expressed reservations about our proposals for gross margin bands and expressed concern that a supplementary cap could reduce allowed net margins.

Summary of evidence

It has provided Board assurance and its CCG has been informed of its proposals and the overall impact on customer bills. Evidence of consumer engagement, particularly regarding bill increases for small customers, is lacking. NERA has provided assurance on Anglian's cost modelling but not the tariff modelling which appears to have been used to prepare the data table submissions.

Assessment of proposal

Anglian Water has provided insufficiently detailed evidence to support its claim for increased costs of £11.9m particularly when these are associated with the implementation of a new target operating model. It is notable that its actual costs of £9.1m in 2015/16 are broadly equal to those allowed at PR14. As discussed in chapter 3 we do not consider that it is clear that the levels of the default tariff caps should be increased to provide additional funding for companies plans to restructure their businesses to compete across the wider market.

It has not been possible to reconcile the narrative in the company's PR16 submission on cost claims with the reduction in costs presented in its data tables where it appears to propose aggregate costs of £8.5m. Furthermore, the data tables do not provide sufficient granularity to map to the simplified structure. Anglian Water's objections to the simplified structure do not appear to recognise the distinction between tariffs and the average revenue controls (which allow for differential pricing for different customer types within a single default tariff cap).

Anglian Water has proposed the introduction of an additional 15 default tariff caps to differentiate between customers paying by direct debit and those on other payment terms. Based on the submission which represents a significant tariff rebalancing some groups of customers will face bill increases of more than 1% and there is no evidence that customers have been engaged on this issue.

Overall, given requests for an increased costs allowance which is not fully supported by the evidence they have provided, issues with the data tables, and apparent significant tariff rebalancing without adequate customer engagement we are unable to accept Anglian Water's proposals.

Decision

We have not been able to accept Anglian Water's proposals for its default tariff caps under 5Ml so we have retained those set at PR14 as the basis for these draft determinations. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.3.6 Northumbrian Water

Summary of company proposal

Northumbrian Water does not support the introduction of uniform gross margin caps and has expressed reservations with respect to the supplementary 1% cap. It has followed our simplification guidance and in its proposals it has reduced the number of default tariff caps from 16 to 8.

In addition to proposing these changes it has raised concerns about its overall retail costs allowance highlighting the risks to inflation arising from the United Kingdom's vote to leave the European Union and that there is additional new evidence on the costs of operating separate retail business arising from the water supply and/or sewerage licences application process. These have been considered as part of our sector wide assessment of cost claims in section 3.1.

Summary of evidence

Northumbrian Water has provided Board assurance of their proposals. There has been no customer engagement as it does not consider that its proposals will have a material impact.

Assessment of proposal

Northumbrian Water has proposed a rebalancing of its PR14 retail cost and margin allocations using 2015-16 data. It has provided limited explanation of its allocation of costs and margins between the 0 to 5Ml and 5 to 50Ml bands. There also appear to be issues with the data tables for wastewater customers using more than 50Ml and inconsistencies between the data tables and narrative in respect of gross margins.

The company expects customer numbers to be 1.6% lower than anticipated at PR14 for a number of reasons including eligibility. It has not made a corresponding reduction to the aggregate business retail costs allowed at PR14 to reflect costs that may now be recovered through the residential retail control.

In terms of price disturbance, it appears that measured water customers in the Southern region would experience a bill increase of 1.6% associated with retail costs increases. However, there is a lack of transparency on bill impacts for smaller customers with volumes below 5 Ml and no evidence of customer engagement.

Taken together, concerns about potential price rises associated with the rebalancing of costs and margins, a lack of customer engagement, and doubts about the accuracy and reliability of its data tables suggests that Northumbrian Water needs to reconsider and/or provide additional information and evidence in support of its PR16 proposals.

Decision

We are unable to accept Northumbrian’s proposals for its PR16 default tariff caps and will retain those set at PR14 for these draft determinations for customers using less than 5Ml. We will apply our uniform gross margin controls for those customers using more than 5MI.

A2.3.7 Thames Water

Summary of company proposal

Thames Water proposes to retain the structure associated with its PR14 default tariff caps as this provides sufficient granularity to map to the new simplified caps for larger customers. It proposes a rebalancing of net margins across their portfolio of default tariff caps, departing from a flat 2.5% across all caps set at PR14. The drivers for this change are the introduction of retail competition and updated information on bad debt costs.

Summary of evidence

Thames Water has provided Board assurance and engaged KPMG to carry out a third party audit of its submission. It has carried out and provided evidence of customer engagement.

Assessment of proposal

Thames Water is not proposing overall cost or margin claims. A revised approach to allocating net margins across its default tariff caps has been developed. While it has updated cost driver information to reflect current data, its proposal lacks detail or external assurance on the rebalancing of costs and margins. It has not demonstrated that its revised margin allocations are attributed to appropriate drivers and activities.

Some customers will experience bill increases as a result these changes. Water and wastewater 0.5 to 1Ml customers will see an increase of 1.3% and 2.1% respectively. It has attempted to support its proposals with evidence of customer engagement but it is not clear whether the specific bill increases for smaller customers were supported by this customer engagement as the Populus report included with the submission refers to significantly lower levels of bill increases.

Thames Water expects a minor reduction in customer numbers (2%) due to eligibility factors but has not made a corresponding reduction to the aggregate business retail costs allowed at PR14.

Decision

Given our concerns about bill impacts for some smaller customers and the apparent inconsistencies between the results of its customer engagement and bill increases we have not accepted Thames Water’s proposals for its default tariff caps for under 5Ml customers and have retained those set at PR14 as the basis for these draft determinations. We will apply our uniform gross margin controls for those customers using more than 5Ml.

A2.3.8 Dŵr Cymru

Summary of company proposal

Dŵr Cymru proposes to reduce the number of its default tariff caps from 20 to 6 consistent with our simplified caps for larger customers. It has reallocated retail costs and margins from its greater than 50Ml bands to other default tariff caps. It also expects customer numbers to reduce but makes no change to its allowed total costs set at PR14.

Summary of evidence

It has provided Board assurance but there is only limited evidence and explanation regarding the reallocation of costs across default tariff caps and there is a lack of clarity on the associated bill impacts, particularly for smaller customers.

Assessment of proposal

Dwr Cymru has reduced the costs allocated to large water customers (those using more than 50Ml water) by over 90% but has provided limited explanation and justification to support these changes.

It has changed its allocation of net margins and proposes a uniform margin of 1.2% across the contestable and non-contestable areas of its retail business. While we understand that the materiality of this change in approach would be limited, we consider that there is no convincing justification for a margin greater than 1% in the non-contestable market segments.

Taken together the costs and margin changes represent a significant rebalancing and we have not been able to properly understand the bill impacts of these proposals.

While customer numbers are expected to fall by 5.5% compared with PR14 Dŵr Cymru proposes maintaining the same level of total retail costs, without providing a convincing supporting explanation as to why the reduction in customers should not be accompanied by a reduction in overall cost allowances.

The combination of these factors means that we have not accepted its PR16 proposals as the basis for these draft determinations.

Decision

We will retain Dŵr Cymru's PR14 default tariff caps for all customers groups except for contestable water customers (with volumes greater than 50Ml) where we will apply our uniform gross margin control.

A3 Addition information

Table A3.1: Company proposals within the water 5 to 50 mega litre uniform band in 2017/2018

Company	Number of customers	Retail cost per customer	Net margin %
Dee Valley Water	179	32	1.0%
Yorkshire Water	1,215	27	1.4%
South West Water	653	92	1.5%
Bournemouth Water	303	46	1.9%
Wessex Water	551	116	2.0%
South Staffs Water	650	69	2.1%
Thames Water	5,962	83	2.1%
South East Water	717	100	2.2%
Portsmouth Water	335	29	2.7%
Northumbrian Water	1,506	237	1.5%
Affinity Water	2,263	156	2.2%
United Utilities	2,395	388	2.1%
Bristol Water	471	243	2.1%
Southern Water	1,091	221	2.2%
Severn Trent Water	2,159	605	1.7%
Sutton & East Surrey Water	190	398	2.5%
Dŵr Cymru	1,216	582	1.2%
Anglian Water	1,299	678	2.4%

Table A3.2: Company proposals within the water over 50 mega litres uniform band in 2017/2018

Company	Number of customers	Retail cost per customer	Net margin %
Southern Water	43	1,008	0.7%
Dŵr Cymru	117	217	1.2%
Yorkshire Water	141	46	1.3%

Anglian Water	9	1,397	1.3%
Northumbrian Water	134	683	1.4%
South Staffs Water	35	221	1.6%
Thames Water	359	168	1.7%
Wessex Water	42	878	1.9%
South East Water	110	107	2.2%
South West Water	50	932	1.8%
Dee Valley Water	15	31	2.5%
Portsmouth Water	28	37	2.5%
United Utilities	714	812	1.5%
Bristol Water	40	828	2.0%
Severn Trent Water	216	2,745	1.1%
Bournemouth Water	4	972	1.8%
Affinity Water	93	1,625	2.0%
Sutton and East Surrey Water	5	1,300	2.5%

Table A3.3: Company proposals within the wastewater 5 to 50 mega litres uniform band in 2017/2018

Company	Number of customers	Retail cost per customer	Net margin %
Yorkshire Water	921	27	1.4%
Northumbrian Water	878	170	1.4%
South West Water	439	113	1.9%
Wessex Water	726	114	2.0%
Southern Water	1,390	332	1.5%
Thames Water	8,145	121	2.1%
United Utilities	3,667	169	2.1%
Anglian Water	1,348	187	2.3%
Severn Trent Water	2,430	429	1.8%
Dŵr Cymru	1,192	618	1.2%

Table A3.4: Company proposals within the wastewater over 50 mega litres uniform band in 2017/2018

Company	Number of customers	Retail cost per customer	Net margin %
Yorkshire Water	128	27	1.3%
Southern Water	54	1,822	0.7%
Dŵr Cymru	127	320	1.2%
Thames Water	575	237	1.9%
Anglian Water	484	559	1.7%
United Utilities	944	544	1.5%
South West Water	87	621	2.0%
Wessex Water	63	1,128	2.0%
Severn Trent Water	224	2,958	1.1%
Northumbrian Water	1,343	465	1.7%

A4 Company acronyms

AFW – Affinity Water

ANH – Anglian Water

BRL – Bristol Water

DVW – Dee Valley Water

NES – Northumbrian Water

PRT – Portsmouth Water

SBW – Bournemouth Water

SES – Sutton and East Surrey Water

SEW – South East Water

SRN – Southern Water

SSC – South Staffs Water

SVT – Severn Trent Water

SWT – South West Water

TMS – Thames Water

UU – United Utilities

WSH – Welsh Water / Dŵr Cymru

WSX – Wessex Water

YKY – Yorkshire Water

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