South Staffs Water

incorporating

Business Retail
2016 Price Review

July 2016

Board Assurance Statement

In approving these revised default tariff caps for the business retail 2016 price review, the Board of Directors confirm that they comply with the following provisions. This statement also sets out how the Board has assured itself of each provision.

1. the information they provide is consistent with their legal obligations (including, where relevant, the prohibitions on undue discrimination or preference in licence condition E and licence condition R, and the charging scheme rules issued by Ofwat under section 143B of the Water Industry Act 1991) and competition law;

Costs and risks have been reviewed and updated where necessary to ensure they are fully reflective of the underlying drivers and are non-discriminatory against any customer group.

2. where appropriate their proposals have been reasonably informed by customer engagement, and research and discussion with their CCG;

We do not have any significant incidence effects arising from the changes we propose, however we have chosen to still conduct customer research on specific elements of our business retail service provision.

We shared the methodology and outcomes of this review with our Customer Panel in meetings in April and July.

3. 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);

Costs were built up on a cost reflective basis as part of the PR14 business plan submission using appropriate cost allocation drivers. The only subsequent change for the business retail 2016 price review is the re-allocation of £4,837 of cost related to large user account management, billing and meter reading.

The net margins have been re-allocated based on independent research commissioned by South Staffs Water using the appropriate risk drivers for each tariff band.

4. data tables have been completed accurately and consistent with any guidance that we have provided.

The Board of Directors have been fully engaged in the methodology of the new default tariff bands, the calculations involved, completion of the tables and development of the submission document. Assurance was completed on the data tables by independent internal audit, in line with our assurance framework.

Approved by the Board of Directors on the 30th June 2016.

Summary Proposals

This document provides detail, evidence and analysis of our proposals, however to summarise our key changes, we propose to simplify and improve our default tariff caps by:

1. Adopting Ofwat's uniform default tariff cap structure, including merging together our unmeasured default tariffs and 0-5 Ml/a default tariff bands;

2. This will be on a combined company basis i.e South Staffs region and Cambridge region default tariff caps have been merged;

3. Overall, ten existing default tariff caps have been merged into three under Ofwat's uniform structure and across both regions;

4. Undertake a small cost reallocation to move key account management, large user billing and large user meter reading costs entirely into the 50+ Ml/a default tariff band; and

5. Alter our net margin allocation across the new default tariff bands based on research we have commissioned with Frontier Economics.

Our approach has been aimed at simplification, reflectivity of costs and reflectivity of risk in the net margin. At the same time we have analysed incidence effects in detail and can confirm that there are no incidence effects arising from these changes that have an impact of greater than 1% on the total customer bill.

We have also commissioned some qualitative customer research. It would have been very difficult to ask customers directly about default tariff caps, so we have instead asked them about tariff choice in a small number of key areas. Overall we can conclude that customer survey results support the changes we have made in moving to a uniform structure. We have also continued to engage with large users via our key account management process. This has provided valuable insight into how these users view our service offering across a range of wholesale and retail themes.

We have engaged with our Customer Panel on the principles and outputs of this review. We have also engaged with CCWater, to who our Customer Panel delegated the detailed review of our methodology. The panel were satisfied with our ability to demonstrate that there are no significant incidence effects and were happy with our final proposals.

PART 1 – Customer research

Ofwat's methodology document for this review indicated that if a company has incidence effects arising from any changes to its default tariffs then it needs to consult with customers. We do not have any significant incidence effects arising from the changes we propose, however we have chosen to still conduct a wide ranging research study that was intended to understand customers' perceptions of the new market as well as specific elements of our business retail service provision. We decided not to ask customers directly about default tariff caps or regulatory price controls as we considered that this technical subject would not be appropriate for survey research. We did however include general questions about tariff structures and customer choice which provided an indication of customers' preferences. The research was conducted in March 2016.

We found that 74% of customers surveyed were not initially aware that they would be able to switch supplier from April 2017. We also found that 50% of customers in our area considered the ability to switch either important or very important. The remaining 50% either considered it unimportant (22%) or did not know (28%). Our research also identified that the most important reasons for switching would be value for money and customer service. In general larger businesses considered water services to be more important and are more likely to switch. This would be expected given the higher level of resources that larger companies can devote to procurement and cost efficiency.

We asked customers two general questions about tariff structures. Firstly we asked how important it was that customers had tariffs that were targeted at their level of consumption. 79% of customers surveyed thought that this was important or very important. We believe this supports the introduction of the smaller 0-5 Ml/a band for all companies since the vast majority of customers are within that small range, and having that band means that default tariffs are more focussed at that consumption level, with the commensurate regulatory protections that a default cap provides. At the large user end, we believe this research supports our current large user charges structure which, uniquely in the industry, uses a reservation tariff that allows tariffs to be specifically targeted to a customer's expected consumption level.

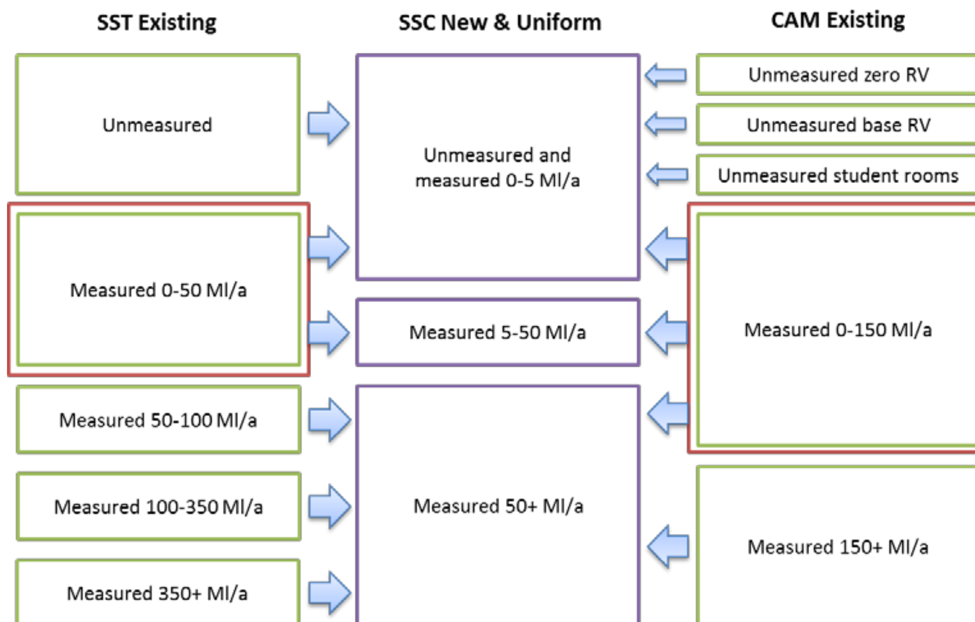
We also asked customers how important it was to have a wide range of tariffs to choose from. 70% thought this was important or very important. Whilst a choice of tariffs is not something we offer as an incumbent for any specific consumption level, we believe this does support the new retail market where customers will have choice across and possibly within retailers for their tariff band.

We have also continued to engage directly with large users as part of our key account management process. Through this direct relationship we have gathered an understanding of the large users' views on our tariff structures and our service provision. Our large users have provided us with valuable feedback on themes such as value added services, tariff seasonality and multi-site billing.

Overall we believe that our proposals in this submission for the 2016 review, stemming from Ofwat's required changes in its methodology, are not in conflict with customer views. Since our proposals do not have significant incidence effects we do not need to engage directly with customers on bill impacts as these are minimal.

Part 2 – Combination of existing default tariff caps into new uniform bands

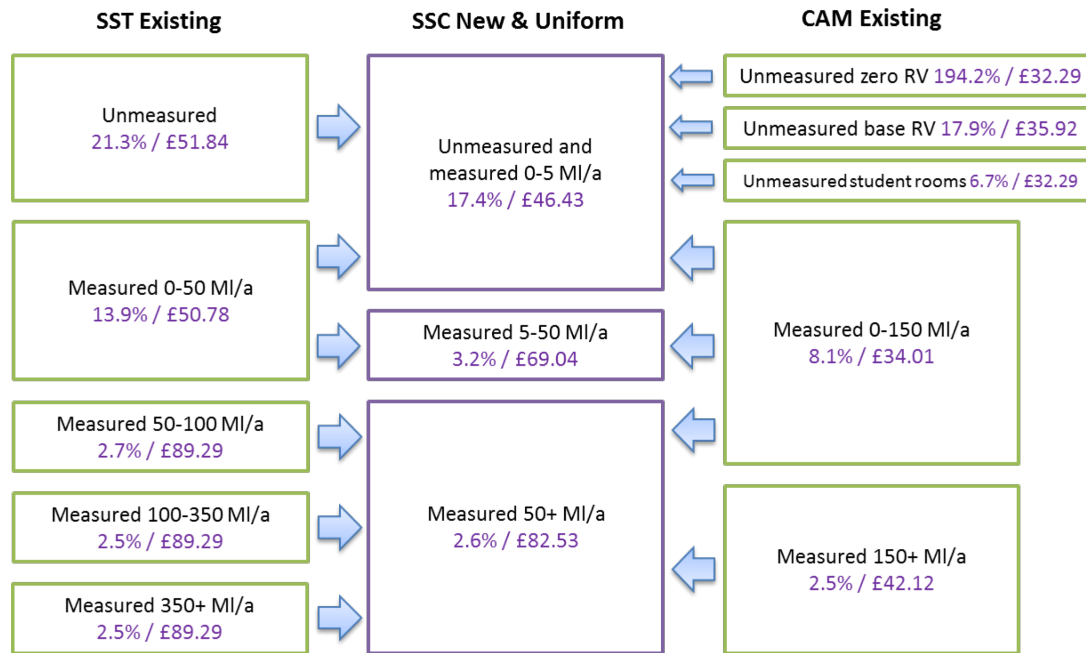
Ofwat's uniform bands intersect our current bands at different points in each region. For the majority of our bands it is a simple aggregation, however two of our bands (one in each region) require separation into more than one new band as they span a boundary point on the new uniform structure. This is shown in the diagram below, where the existing bands requiring separation are outlined in red.



The SST measured 0-50 Ml/a band requires separation into 0-5 and 5-50 Ml/a; and the CAM measured 0-150 Ml/a band requires separation into all three of the new uniform bands. The cost allocation we used at PR14 was of sufficient granularity to enable us to perform this separation without altering any of the cost allocation rules we used at the time or introducing any new assumptions. We can therefore fully reconcile the revised default tariff caps with the existing ten default tariff caps. In itself this change does not alter any of the underlying charges to customers in either region, because we can maintain our existing end user charges, including the current bill differential between SST and CAM regions, and comply with the new combined default tariff caps. We have also opted to merge our unmeasured and 0-5 Ml/a groups together, as the gross margin and average cost to serve were similar and this helps to further simplify the structure.

More detail on how we have separated and re-combined our costs to form the new tariff bands is provided in appendix 1. We have also provided a copy of Ofwat's spreadsheets with only this change for reference purposes.

The following diagram shows the existing gross margin percentages and average cost to serve for each of the existing and new default tariff bands. For this diagram we have kept the same 2.5% net margin across all bands to enable a like for like comparison with our existing default tariffs. Note that these figures are provided for year 2017/18 only but the principle remains identical for the following two years.



In performing this analysis we have identified two costs which we propose to reallocate into the large user group.

The first cost is for key account management and large user billing. We have identified that this cost, totalling £4,420 per annum, was split over all business retail customers in the price control. We believe that it is more cost reflective if we reallocate this cost entirely to the measured 50+ Ml/a default tariff, as this is the only group where we undertake dedicated account management services and where we have to manually bill large users.

The second cost is for large user meter readings. At PR14 we did not reflect the fact that large users tend to have multiple meters on their premises, and we therefore applied the same base unit cost for all business retail customers. We believe that it is more cost reflective if we reallocate meter reading costs of approximately £417 per annum to the 50+ Ml/a group, as this is the only group that has multiple on site meters.

These cost reallocations have the combined effect of raising the average cost to serve for the 50+ Ml/a group. The cost to be reallocated is small in absolute terms and therefore has minimal impact on the other two default tariffs, as shown in the table below:

	Before cost reallocation		After cost reallocation		
Default tariff	**Gross margin**	**ACTS**	**Gross margin**	**ACTS**	**Incidence effect**
0-5 Ml/a	17.4%	£46.43	17.4%	£46.31	-0.032%
Measured 5-50 Ml/a	3.2%	£69.04	3.2%	£68.93	-0.001%
Measured 50+ Ml/a	2.6%	£82.53	2.7%	£220.64	+0.098%

We believe this is a fairer reflection of the average cost to serve for the largest users, and the incidence effects from the change are insignificant on the total bills for all groups.

Part 3 – Net margin allocation

At PR14 we applied a uniform 2.5% net margin across all ten of our default tariffs on the basis that we had no additional evidence to justify an alternative split. Since PR14 our understanding of the importance of the risk reflectivity has increased and we therefore considered that it was prudent to commission a study into our net margin allocation. We commissioned Frontier Economics to carry out research and model our net margin allocation.

Frontier Economics has calculated the combined company net margin for Ofwat's proposed uniform measured bands, plus a single combined unmeasured band. The methodology used is as follows:

- Four risk categories analysed:
  - Return on assets (fixed assets and working capital);
  - Return to cover bad debt risk;
  - Return to cover retail cost risk; and
  - Residual risk.
- Fixed assets are allocated on the basis of customer numbers.
- Working capital requires a financing rate of 3%, all other capital requires a financing rate of 15%.
- Retail cost by tariff band is consistent with the PR14 Final Determination.
- Residual return is the balancing factor to achieve an overall 2.5% net margin across the entire business retail price control. This is spread proportionally across the default tariff bands using customer numbers – i.e each customer takes an equal share of the residual risk, which we believe is the simplest and fairest approach.

Two scenarios have been developed using this approach, the first based on a retail cost risk of 2%, and the second based on a higher 5% value – these outputs are shown below. Note that in each scenario the average margin remains at 2.50% as a total for the price control.

Both scenarios are derived, as explained above, from the assessment of four risk drivers. This information is shown in the table below. Note that return on assets has been further sub-divided into its two component parts of fixed assets and working capital.

	Scenario A (2% retail cost risk)					
Customer group	Fixed assets	Working capital	Bad debt risk	Retail cost risk	Residual risk	Final net margin
Unmeasured	0.44%	-0.85%	0.03%	0.31%	1.38%	1.31%
Measured 0-5 Ml/a	0.36%	1.11%	0.02%	0.17%	1.35%	3.02%
Measured 5-50 Ml/a	0.01%	0.56%	0.02%	0.16%	1.36%	2.12%
Measured 50+ Ml/a	0.00%	0.30%	0.02%	0.01%	1.37%	1.70%

	Scenario B (5% retail cost risk)					
Customer group	Fixed assets	Working capital	Bad debt risk	Retail cost risk	Residual risk	Final net margin
Unmeasured	0.44%	-0.85%	0.03%	0.78%	1.15%	1.55%
Measured 0-5 Ml/a	0.36%	1.11%	0.02%	0.42%	1.13%	3.05%
Measured 5-50 Ml/a	0.01%	0.56%	0.02%	0.41%	1.14%	2.14%
Measured 50+ Ml/a	0.00%	0.30%	0.02%	0.02%	1.15%	1.49%

The data shows primarily that some risk components are very small. There is also an observable difference between the unmeasured customers and the measured customers, primarily as the unmeasured customers pay in advance rather than in arrears, which influences the working capital requirements.

In scenario B, the greater level of retail cost risk is offset by a lower residual risk component.

The Frontier Economics report containing the full methodology and results has been submitted to Ofwat alongside this document.

Our proposal is to revise our net margin allocation to our default tariff caps on the basis that it is a justified and risk reflective allocation. This results in net margins which are comparable to those that other companies put forward at PR14, as only a small number of companies had a uniform 2.5% net margin across the whole range.

As we have two scenarios based on differing retail cost risk, we propose to use an average of the two for our final value. For the unmeasured and 0-5 Ml/a tariff bands which we propose to merge into one, a merged net margin has been calculated. Our proposed net margin allocation is shown below along with the gross margins and high level incidence effects that result from this change. The incidence effects are less than 1% of the total bill for all groups.

	Existing structure[1]		Revised structure		
Default tariff	**Existing net margin**	**Existing gross margin**	**Revised net margin**	**Revised gross margin**	**Incidence effect**
Unmeasured and measured 0-5	2.50%	17.4%	2.96%	17.9%	+0.416%
Measured 5-50	2.50%	3.2%	2.13%	2.8%	-0.362%
Measured 50+	2.50%	2.7%	1.60%	1.8%	-0.781%

[1] after applying our part 2 cost reallocations (which have only a very small effect on gross margin).

Both the existing and revised structures are based on the same cost allocation as described in part 2. Therefore this table demonstrates the direct effect of changing only the net margin allocation.

Part 4 – Accompanying spreadsheets

We have provided two sets of data tables with this submission. In both cases we have set all existing default tariffs as ‘not used from 2017’ and we have created three new tariffs with the appropriate customer numbers, costs and net margin values.

1. We have completed a version of Ofwat’s data tables as if the only change was the amalgamation of our existing ten tariff bands into the three new unform bands. This therefore excludes the small cost reallocations discussed in part 2 and the net margin changes discussed in part 3. For the avoidance of doubt please note that this is not the proposal we would like to take forward and is provided on a comparative basis to PR14 only.

   This file is titled ‘(1) SSC PR16 – PR14 Comparison.xlsm’

2. We have also completed a second version of Ofwat’s data tables which includes our small changes to cost allocations as discussed in part 2, and our changes to net margin allocation as discussed in part 3. This is the default tariff structure that we propose to go forward with.

   This file is titled ‘(2) SSC PR16 – Final Proposals.xlsm’

Part 5 - Assurance

The Board of Directors have been fully engaged in the methodology of the new default tariff bands, the calculations involved, completion of the tables and development of the submission document. The Board has undertaken the following processes to ensure the quality and transparency of data:

1. The Board has undertaken a risk assessment in line with its assurance framework. A summary of the output is as follows:

Risk Score			
Likelihood Score	Impact Score	Total Risk Score	Assurance Risk Category
2	4	8	Medium

The likelihood score is medium, reflecting the fact that the majority of data is taken directly from information that was assured by a third party as part of the 2014-15 year end reporting as part of the annual KPI reporting or the regulatory accounts.

In addition, the staff involved in collating the information have been with the Company for a number of years and so are familiar with the data sources and the completion of the tables at PR14, as well as having full understanding of default tariffs and the changes that Ofwat's final methodology introduces.

The impact score is critical as a result of the potential significant impact on the new retail market and competition law.

Overall, the total risk score is medium in line with our framework scoring matrix. As a result, and in line with the assurance framework, we have used independent internal assurance to verify the data provided.

2. The data tables and this commentary document were reviewed and approved at a meeting of the Directors held on the 30th June 2016, subject to the outcome of the independent internal assurance which was successfully completed. The assurance report is provided in appendix 2.

Part 6 - Customer Panel

We began to form our new customer panel in early 2016 and at its first meeting in April we discussed this default tariff review. Our panel identified that customer incidence effects were the issue of highest priority. We explained to our panel that we did not expect the review to generate incidence effects of greater than 5% (the threshold used in the charges review each year). Ofwat has since clarified that a 1% threshold would be more appropriate for this review. We agreed to report back to the panel in its July meeting, just before the submission date of this review, on the final results and outcomes.

Following the April meeting the Customer Panel agreed to delegate the detailed review of our methodology and outcomes to the CCWater panel member. We visited CCWater on 28th June where we talked through the end to end methodology. We agreed to prepare a focused review of small customers incidence effects for the CCWater panel member to feed back to the full panel at its July meeting.

Our customer panel were provided with the full results as presented in this submission document in their July meeting, and an accompanying presentation on incidence effects for small customers in which we demonstrated that no individual customer will suffer any incidence effects over the 1% threshold. The table provided below was presented to the Customer Panel and demonstrates the range of incidence effects for measured customers in the 0-5 Ml/a range, and unmeasured customers, in both regions.

	SST		CAM	
Consumption or RV	**Measured**	**Unmeasured**	**Measured**	**Unmeasured**
50	0.31%	0.40%	0.28%	0.42%
100	0.37%	0.40%	0.35%	0.42%
200	0.41%	0.40%	0.40%	0.42%
500	0.44%	0.40%	0.43%	0.42%
5000	0.46%	0.40%	0.46%	0.42%

The Customer Panel were satisfied with our ability to demonstrate that there are no significant incidence effects and were happy with our final proposals.

Part 7 - Conclusions

In arriving at our proposed default tariff caps we have:

Activity	Outcome and summary justification
Commissioned customer research into tariff preferences with customers in both regions and of varying sizes.	We have undertaken a one off research study into business customer perceptions and also continually engage with our larger customers via our key account management process.We believe that there is no conflict between what customers are telling us and the principles used for amalgamating default tariffs in this review. Incidence effects are not significant and therefore we have not engaged directly with customers on this, however we have engaged with our Customer Panel throughout the process including on the final proposals.
Undertaken an exercise to merge our existing ten default tariffs into three combined, uniform, default tariffs aligned to Ofwat's desired structure.	We have merged our existing ten default tariffs across both regions into three, aligned with Ofwat's structure. We have also chosen to merge unmeasured default tariffs with the measured 0-5 Ml/a group as the gross margins and average cost to serve were similar, which helps simplify the structure. As we did not need to change any underlying cost allocation assumptions or values to perform the alignment, there is no impact to customer bills from this change. We are able to maintain the existing underlying end user charges, including the existing bill differential across regions, whilst still complying with the new uniform default tariff caps.
Reallocation of two costs (key account management and large user meter reading) entirely into the 50+ Ml/a default tariff.	We identified that at PR14 we had allocated the costs of key account management, large user billing and large user meter reading across all default tariffs. We believe that this is not cost reflective as these services only apply to large users falling into the 50+ Ml/a tariff band. At PR14, the future impact of this small element of cost being allocated in this way was not known and this price review is an opportunity to resolve this in the interests of cost reflectivity in the new market. Reallocating these costs increases the cost to serve for the 50+ Ml/a band whilst having almost zero impact on the two smaller bands. Incidence effects are also insignificant as the reallocated costs are small in relation to the much larger wholesale charges and associated net margin recovery for the 50+ Ml/a group.
Commissioned Frontier Economics to model our net margin allocation based on four risk drivers.	At PR14 we applied a uniform 2.5% net margin across all ten of our default tariffs on the basis that we had no additional evidence to justify an alternative split. We considered that for this review, and as our understanding of the importance of the risk reflectivity of the net margin has increased since PR14, it was prudent to commission a study into our net margin allocation. Frontier Economics found that there was strong evidence for an alternative allocation of net margin based on the underlying risk drivers, which we therefore propose to adopt. The margin trend we propose is consistent with that of other companies' net margin allocations at PR14.

Appendix 1 – Merging of existing tariff bands

1. Introduction to Appendix
This appendix describes the methodology that has been used to calculate and split out customer numbers, wholesale costs and retail costs for business customers in the South Staffs and Cambridge regions. All data that has been used within our analysis has been taken from the 13/14 charging year.

2. Methodology and Approach
The data that will be utilised within our calculations for both the wholesale and retail elements of our cost calculations has been sourced from our 13/14 data, which formed part of business plan submission at PR14. This data provides us with a detailed breakdown of the cost drivers that are required to separate our data into the newly revised bands, by splitting and reallocating the data and figures into the following components:

- Customer numbers
- Retail costs
- Wholesale costs

Although the values used for the above components were specific to the 13/14 charging year, for the purpose of modelling, these have been apportioned forward to reflect the figures for the 17/18, 18/19 and 19/20 charging years for a consistent allocation of cost. Using this method of calculation was also considered most practical as it allows for us to keep our starting position consistent with our PR14 business plan data.

2.1. Separation of Tariff Bands
Further to Owat's requirements for separation, the following tariff bands needed to be split:
- In the Cambridge region the existing 0-150 Ml/a band is required to be split into 0-5Ml/a, 5-50 Ml/a and 50+ Ml/a tariff bands.
- In the South Staffs Region, the existing 0-50 Ml/a tariff band is required to be split into 0-5Ml/a and 5-50 Ml/a tariff bands.
- Our data set for 13/14 is at an individual customer account level and split by cost drivers. This enables us to aggregate upwards into the new default tariff groups.

2.2. Separation of Customer Numbers
This section sets out the methodology used to split out 13/14 customer numbers in both the South Staffs and Cambridge regions.

For the Cambridge region we used our 'Metered Consumption in Period' report for 13/14. This report lists all business customers in the Cambridge region, along with their annual consumption figures for each charging year on an individual customer basis. This report allowed us to easily allocate customer numbers to the new default tariff groups in accordance with their consumption per annum.

In the Cambridge region, at 4 Ml/a customers are switched from 2 meter reads per year and semi-annual billing, to 4 meter reads and quarterly billing. As part of our methodology for separation, we have ensured that all customers below 5 Ml/a were categorised within the 0-5 Ml/a band.

For the South Staffs region we used our 'Business Customer Consumption' report, which displays customer numbers and annual consumption values for customers using between 1 Ml/a and 50 Ml/a. This report allowed us to easily allocate customer numbers to the new default tariff groups in accordance with their consumption per annum.

In the South Staffs region, at 6 Ml/a, customers are switched from 1 meter read per year and semi-annual billing, to 12 meter reads and monthly billing. We have also ensured that all customers with consumption levels above 5 Ml/a are allocated to the 5-50 Ml/a tariff band.

Once we had rebalanced the customer numbers into the new default tariff groups for 13/14, we were able to calculate the numbers for the 17/18, 18/19 and 19/20 charging years by apportioning the percentage weightings for each of the associated 13/14 customer numbers. Our calculations on customer numbers for the forthcoming charging review periods are provided below:

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Customer Numbers CAM	Original:	9,315	9,352	9,389
New band	13/14 proportion	split into new bands		
0-5	97.55%	9,087	9,123	9,159
5-50	2.41%	225	226	227
50-150	0.03%	3	3	3

Separation of SST 0-50 band		2017-18	2018-19	2019-20
Customer Numbers SST	Original:	27,640	27,865	28,140
New band	13/14 proportion	split into new bands		
0-5	98.46%	27,214	27,436	27,707
5-50	1.54%	426	429	433

2.3. Separation of Wholesale Costs

This section sets out the methodology used to split out 13/14 wholesale costs.

For both the Cambridge and South Staffs regions, our consumption reporting data as at 13/14 provided consumption and wholesale revenue, split at an individual customer account level. This allowed us to easily categorise wholesale costs into new default tariff groups.

Once consumption for 13/14 at an individual customer level had been split into the relevant tariff bands, we were able to determine the associated wholesale costs for the 17/18, 18/19 and 19/20 charging years, by apportioning the percentage weightings for each of the associated 13/14 wholesale costs. Our costing calculations for the forthcoming charging review periods split by the new Ofwat tariff bands are provided below:

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Wholesale Costs CAM	Original:	5.76	5.69	5.65
New band	13/14 proportion	split into new bands		
0-5	55.35%	3.19	3.15	3.13
5-50	40.76%	2.35	2.32	2.30
50-150	3.89%	0.22	0.22	0.22

Separation of SST 0-50 band		2017-18	2018-19	2019-20
Wholesale Costs SST	Original:	12.64	12.65	12.81
New band	13/14 proportion	split into new bands		
0-5	67.79%	8.57	8.58	8.68
5-50	32.21%	4.07	4.07	4.13

2.4. Separation of Retail Costs

This section sets out the methodology used to determine 13/14 business retail costs, which were then split into the new default tariff groups.

In both the Cambridge and South Staffs regions, our source data was taken from business retail cost reports as at the 13/14 charging year. These reports contain detailed cost drivers, which allowed us to separate retail costs in to the new default tariff groups. Our cost drivers are unchanged from PR14.

We determined the associated retail costs for the 17/18, 18/19 and 19/20 charging years by apportioning the percentage weightings for each of the associated 13/14 retail costs per tariff band. Our costing calculations for the forthcoming charging review periods split by the new default tariff bands are provided below:

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Retail Costs CAM	Original:	316,747	315,540	315,626
New band	13/14 proportion	split into new bands		
0-5	96.97%	307,135	305,965	306,048
5-50	2.99%	9,484	9,448	9,451
50-150	0.04%	128	127	127

Separation of SST 0-50 band		2017-18	2018-19	2019-20
Retail Costs SST	Original:	1,403,491	1,377,285	1,364,492
New band	13/14 proportion	split into new bands		
0-5	97.48%	1,368,073	1,342,528	1,330,058
5-50	2.52%	35,418	34,757	34,434

3. Cost Allocation Adjustments

Following our separation, calculation and apportionment of the three components listed above, the next phase of our analysis was to examine the cost driver principles we had used at PR14 to determine if they remained robust..

Our retail cost calculations at PR14 had included a provision for key account management and large user billing at an annual cost of £4,420, which was previously allocated equally across all business customer tariff bands. We recognised that the costs to cover these functions should only be applied to customers with high consumption who receive this bespoke service and as such, these costs have been been reallocated entirely to the 50+ Ml/a tariff band in our final proposal.

We have also assessed the number of meters that business customers had on a single site, and subsequently the additional time taken for meter readers to complete meter reads whilst on site, which was not considered at PR14. To be further cost reflective we have reallocated a small cost to the 50+ Ml/a group, to reflect the additional time taken for meter readers to cover sites which have multiple meters. This allocation is based on the calculation of the unit cost for a meter read and the assumption of an additional cost of 10% (as a percentage of the existing unit cost) for each additional meter that is read whilst a meter reader is on site. When apportioned forward to reflect 17/18, the amount to be reallocated to the 50+ Ml/a group is £417 per annum.

Appendix 2 – Assurance report

SOUTH STAFFORDSHIRE WATER PLC – INTERNAL AUDIT REPORT

Subject Matter: Business Retail Calculations

Introduction

In preparation for business retail competition which is due to commence in April 2017, Ofwat requires South Staffordshire Water (SSC) to split out customer numbers, wholesale costs and retail costs for business customers in the South Staffs (SST) and Cambridge regions (CAM), into newly allocated default tariff groups.

Previously SST had a category <50Ml/year. This category needs to be broken down into two new categories 0-5Ml/year and 5-50Ml/year. In CAM region the category previously reported to Ofwat was <150Ml/year. This category needs to be broken down into three new distinct categories 0-5Ml/year, 5-50Ml/year and 50+ Ml/year.

Objective and Scope of the Audit

SSC's regulation department have produced the revised numbers having undertaken a detailed analysis of customer data for 2013/14 and information contained in the R4 table used in the Business Plan Submission at PR14.To provide the business with assurance, Internal Audit was requested to review the reported numbers to confirm accuracy and validity. Prior to the audit performed on Monday 11 July 2016, The Regulation Unit provided Internal Audit with detailed notes setting out the methodology used to support the business retail calculations. The figures put forward for Audit are set out in the six tables below:

Separation of SST 0-50 band		**2017-18**	**2018-19**	**2019-20**
Retail Costs SST		1,403,491	1,377,285	1,364,492
New band	Proportion	split into new bands		
0-5	97.48%	1,368,073	1,342,528	1,330,058
5-50	2.52%	35,418	34,757	34,434

Separation of SST 0-50 band		**2017-18**	**2018-19**	**2019-20**
Wholesale Costs SST		12.64	12.65	12.81
New band	Proportion	split into new bands		
0-5	67.79%	8.57	8.58	8.68
5-50	32.21%	4.07	4.07	4.13

Separation of SST 0-50 band		2017-18	2018-19	2019-20
Customer Numbers SST		27,640	27,865	28,140
New band	Proportion	split into new bands		
0-5	98.46%	27,214	27,436	27,707
5-50	1.54%	426	429	433

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Retail Costs CAM		316,747	315,540	315,626
New band	Proportion	split into new bands		
0-5	96.97%	307,135	305,965	306,048
5-50	2.99%	9,485	9,448	9,451
50-150	0.04%	128	127	127

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Wholesale Costs CAM		5.76	5.69	5.65
New band	Proportion	split into new bands		
0-5	55.35%	3.19	3.15	3.13
5-50	40.76%	2.35	2.32	2.30
50-150	3.89%	0.22	0.22	0.22

Separation of CAM 0-150 band		2017-18	2018-19	2019-20
Customer Numbers CAM		9,315	9,352	9,389
New band	Proportion	split into new bands		
0-5	97.55%	9,087	9,123	9,159
5-50	2.41%	225	226	227
50-150	0.03%	3	3	3

Audit Work and Observations

The key audit work performed included:

- Confirmation that the correct numbers have been used for the years 2017-18, 2018-19 and 2019-20 by reference to the PR14 submission.
- Checking the logic used to determine the proportion numbers used.
- Checking the calculations.
- Checking the average consumption figures in terms of reasonableness.

Have the correct numbers been used for the years 2017-18, 2018-19 and 2019-20 by reference to the PR14 submission?

Internal Audit checked the figures presented to the information contained in PR14 information R4.

	2017-18	2018-19	2019-20	Figures Agreed
Retail Costs SST 0-50	1,403,491	1,377,285	1,364,492	Yes
Wholesale Costs SST 0-50	12.64	12.65	12.81	Yes
Customer Numbers SST 0-50	27,640	27,865	28,140	Yes
Retail Costs CAM 0-150 [1]	316,747	315,540	315,626	Yes
Wholesale Costs CAM 0-150	5.76	5.69	5.65	Yes
Customer Numbers CAM 0-150	9,315	9,352	9,389	Yes

[1] There were minor differences between the figures reported and the R4a report for Retail costs in the CAM region. These were in respect of rounding differences and have been rectified.

The figures used for 2017-18, 2018-19 and 2019-20 are accurate and are supported by the PR14 schedule.

The logic used to determine the proportion numbers

South Staffs Region (SST)

In the SST region the large user report generated by Rapid was used to produce the figures for customer numbers, consumption and retail costs. Internal Audit has confirmed the numbers being reported to the large user report.

These above figures have been used to determine the proportions as follows:

	% 0-5Ml	% 5-50Ml	Agreed
Retail Costs SST 0-50	97.48%	2.52%	Yes
Wholesale Costs SST 0-50	67.79%	32.21%	Yes
Customer Numbers SST 0-50	98.46%	1.54%	Yes

Cambridge Region (CAM)

In the CAM region the metered consumption report (R163) for 2013/14 was used to produce the figures for customer numbers, consumption and retail costs. Internal Audit has confirmed the numbers being reported to the R163 report.

These figures have been used to determine the proportions as follows:

	0-5Ml	5-50Ml	% 0-5Ml	Agreed
Retail Costs CAM 0-50	96.97%	2.99%	0.04%	Yes
Wholesale Costs CAM 0-50	55.35%	40.76%	3.89%	Yes
Customer Numbers CAM 0-50	97.55%	2.41%	0.03%	Yes

Calculations

Internal Audit has checked all calculations contained within the tables presented and can confirm they are accurate.

Reasonableness

Internal Audit has calculated the average consumption used in both SST and CAM regions to highlight any potential issues with either consumption or customer numbers. No issues were found.

Conclusion

From the audit work performed, the six tables presented to Internal Audit have been checked to supporting documentation. Internal Audit has also performed tests to confirm the accuracy of these numbers. In conclusion, the figures presented by the Regulation department are accurate and in line with the methodology provided.

Glyn Palmer
Internal Audit Manager
July 2016

Appendix 3 – Frontier Economics report on net margin allocation

This report has been enclosed with our submission to Ofwat.